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IMPACT OF THE TAX SYSTEM ON PRODUCTIVITY IN SMALL BUSINESS AND AGRICULTURE

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

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IMPACT OF THE TAX SYSTEM ON PRODUCTIVITY IN SMALL BUSINESS AND AGRICULTURE

MONDAY, MAY 21, 1984

U.S. SENATE,
COMMITTEE ON FINANCE,
SUBCOMMITTEE ON OVERSIGHT
OF THE INTERNAL REVENUE SERVICE,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:41 a.m., in room SD-251, Dirksen Senate Office Building, Hon. Charles Grassley presiding.

Present: Senator Grassley.

[The press release announcing the hearing and the opening statement of Senator Grassley follows:]

[Press release—for immediate release May 10, 1984]

U.S. Senate, Committee on Finance, Subcommittee on Oversight of the Internal Revenue Service, SD-219 Dirksen Senate Office Building

FINANCE SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE SETS HEARING ON IMPACT OF THE TAX SYSTEM ON PRODUCTIVITY IN SMALL BUSINESS AND AGRICULTURE

Senator Charles E. Grassley (R., Iowa), Chairman of the Finance Subcommittee on Oversight of the Internal Revenue Service, announced today that the Subcommittee will hold a hearing to examine the impact of the Federal income tax system on productivity in the economic areas of small business and agriculture.

The hearing will be held on Monday, May 21, 1984 at 9:30 a.m. in Room SD-215 of the Dirksen Senate Office Building.

"Most discussion with respect to productivity has related to the overall macroeconomic effects of the tax system on land, labor and capital with particular emphasis on capital formation. These hearings will attempt to examine individual influences such as inventory valuation, modernization, and capacity utilization."

Senator Grassley noted that "witnesses should be prepared to address such productivity issues as how our tax system and its administration by the Internal Revenue Service affects small business and the agriculture industry with regard to their productivity goals."

OPENING REMARKS OF SENATOR GRASSLEY

The Subcommittee on Oversight of the Internal Revenue Service today continues its series of hearings on the impact of the Internal Revenue Code on productivity in America. These hearings are of vital importance to the economy and to American farmers and workers. We are especially pleased that such distinguished witnesses have agreed to appear and testify.

Most discussion and analysis with respect to productivity have focused on the overall macroeconomic effects of the tax system on land, labor, and capital, with particular emphasis on capital formation. These are important considerations. But so are the microeconomic effects of the tax system. These hearings will attempt to examine individual, microeconomic influences such as inventory valuations, modernization, and capacity utilization.

In planning these hearings, Subcommittee staff has asked witnesses to be prepared to address such productivity issues as how the tax system and its administration by the Internal Revenue Service affect the productivity goals of small business and agriculture. What are the stimulants, the barriers, the outright prohibitions that affect productivity? Which tax provisions affect profitability, or are incentives or disincentives to entering agriculture or small business?

The ultimate purpose of these hearings is to provide the Congress with information, analyses, and suggestions that will lead to fundamental tax reform. Let me stress the word "fundamental." I know of few issues more critically important to the long-term well-being of our citizens than the issue of fundamental tax reform. Not only farmers and small businesspeople have a stake in this matter. All taxpayers have a stake in it. The present system is overburdened with complexity, unfairness, and inefficiency. Let us get at the root causes of these qualities. It is these considerations that are the central concern of the Subcommittee hearings.

We begin the hearing today with witnesses who will address the issue of productivity in the agricultural industry. American agriculture is currently experiencing economic problems. Natural and economic forces have combined to cause hardship in many areas of our country and in many sectors of agriculture. These are problems that the Nation as a whole cannot afford to disregard.

It is against this backdrop that we will examine the pressures that the Internal Revenue Code exerts on individual farmers. I want the witnesses to describe for the Subcommittee what it is like to be an American farmer, to face the complex array of tax laws that emanate from Washington. How do these tax provisions affect the day-to-day business decisions of the farmer? How do they affect the farmer's capacity to produce crops and livestock? How do they affect the farmer's ability to pass the business along to the next generation?

This morning, we will also address issues relating to small business. It is no secret that entrepreneurship is the lifeblood of the American economy. Even in this supposed era of the multinational conglamerate, small business in this country produces more new jobs and usually grows at a faster annual rate than big business. Small business accounts for nearly half of the non-government, non-farm employment, produces some 42 percent of sales, and accounts for about 38 percent of Gross National Product. Beyond that, small business sparks innovation in American industry, and undoubtedly is a major factor in keeping the United States competitive on the international scene.

I would like to ask the witness to be as specific as possible in analyzing tax provisions that affect the entrepreneur who is considering starting up a small business, the owner-manager who is already established but wants to hire more people and expand, the successful businessperson who may face an economic downturn temporarily, and other kinds of people in small business. Let's try to see the world as they view it, and to analyze the Internal Revenue Code as it affects them in very real human and economic terms.

Senator GRASSLEY. I would like to call this meeting and this hearing of the Subcommittee on Oversight of the Internal Revenue Service to order and thank everybody for participating—those who are in the audience as well as people who are on the various panels and speakers for helping us to look at this very important subject of productivity in America and the impact of the Tax Code upon productivity.

This is the second in a series of hearings that we have had on this subject. The first hearing occurred about 1 month ago.

We are in the pursuit of the impact today of the Tax Code and productivity on the economy, and particularly as it relates to small business, the American farmers, and the workers. We are especially pleased that such distinguished witnesses that we have invited have agreed to appear and to testify. Most discussion and analysis with respect to productivity has focused on the overall macroeconomic effects of the tax system on land, labor, and capital, with particular emphasis on capital formation. These of course are important considerations, but so are the microeconomic effects of the tax system.

These hearings will attempt to examine individual microeconomic influences such as inventory valuations, modernization, and capacity utilization.

In planning these hearings, the subcommittee staff has asked witnesses to be prepared to address such productivity issues as how the tax system and its administration by the Internal Revenue Service affect the productivity goals of small business and agriculture. What are the stimulants? The barriers? The outright prohibitions against effective productivity?

Which tax provisions affect profitability, or are incentives or disincentives to entering agriculture or small business present?

The ultimate purpose of these hearings is to provide the Congress with information, analyses, and suggestions that will lead to fundamental tax reform.

Let me stress the word "fundamental." I know of few issues more critically important to the long-term well-being of our citizens than the issue of fundamental tax reform. Not only farmers and small business people have a stake in this matter; all taxpayers also have a stake.

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cessful business person who may face an economic downturn temporarily, and other kinds of people who are going to make their livelihood through small business.

If we can, let's try this morning to see the world as these people in small business and agriculture view it, and to analyze the Internal Revenue Code as it affects them in very real, human, and economic terms.

Our first witness today, already at the witness table, is the Honorable D. Bruce Merrifield, Assistant Secretary for Productivity, Technology and Innovation of the U.S. Department of Commerce, Washington, DC.

I want to publicly thank Dr. Merrifield for what I told him privately. I know that he had to go to a lot of extra trouble to be here this morning, especially after we changed the meeting date of this hearing, and I want to thank him for his cooperation in that area.

Thank you. Would you proceed, please?

STATEMENT OF HON. D. BRUCE MERRIFIELD, ASSISTANT SECRETARY FOR PRODUCTIVITY, TECHNOLOGY AND INNOVATION, U.S. DEPARTMENT OF COMMERCE, WASHINGTON, DC

Dr. MERRIFIELD. Thank you, Mr. Chairman. I am happy to be able to be here. I would like to ask that my written testimony be entered in the record, and then I would like to comment on it.

Senator GRASSLEY. All right.

At this point, let me also make an administrative announcement that is quite typical: I would like to say to each of the witnesses that, unless you would direct otherwise, your entire statement will be printed in the record, and then we would encourage you to summarize.

We would remind you that the record will be open for about 15 days for any additions, corrections, deletions to the printed record, and also that either I as chairman of this committee or maybe even members who can't be here may have questions in writing that we will want to and will submit to you, and we ask that those be back from each of the witnesses that might receive them within that 15 day period of time.

So, proceed.

Dr. MERRIFIELD. Thank you.

[Dr. Merrifield's prepared statement follows:]

STATEMENT OF
D. BRUCE MERRIFIELD
ASSISTANT SECRETARY OF COMMERCE
FOR PRODUCTIVITY, TECHNOLOGY AND INNOVATION
BEFORE THE SUBCOMMITTEE ON OVERSIGHT
OF THE INTERNAL REVENUE SERVICE OF THE
SENATE FINANCE COMMITTEE

MAY 21, 1984

ENCOURAGING PRODUCTIVITY GROWTH

Mr. Chairman and members of the Committee, thank you for the opportunity to discuss my views on the economic factors influencing productivity and on the importance of our tax laws to the growth of productivity. It is well established that technological innovations are one of the principal sources of long-term improvements in the productivity of any national economy. In fact, the industrial world is increasingly technology driven. In my testimony today, I will focus on how technological innovation can contribute to productivity growth. In particular, I will emphasize the importance of small businesses and start-up businesses in the innovation process.

Productivity is a synonym for the ratio of output to the set of inputs used in its production. Increasing productivity is essential if U.S. businesses is to compete in world markets, particularly as other nations become more aggressive

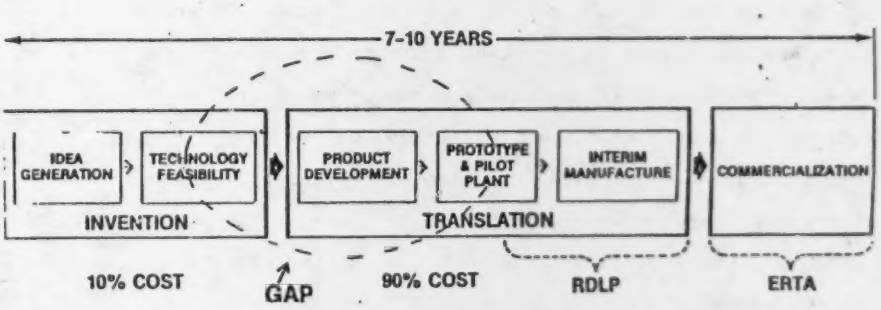
competitors. Productivity gains can result from many factors including (1) incremental improvements in existing operations or (2) innovative discoveries that create a new, more efficient way of doing the same thing. Though both approaches need to be improved, I want to concentrate on the role of innovation. In the area of innovation the appropriate role of government is supportive while urging reliance on the market economy. It involves primarily the following actions:

- o increasing basic research funding to increase the pool of fundamental knowledge;
- o removing barriers to the translation of fundamental knowledge into useful products, processes, and services;
- o providing improved incentives for the innovation process;
- o providing data and assessments of worldwide competitive conditions for strategic planning by business; and
- o providing information and education to catalyze private sector initiatives.

I am particularly concerned that adequate funds, be available to American business to ensure that no bottlenecks develop which might prevent U.S. firms from fully exploiting the benefits of our substantial annual expenditures for basic research. To explain my concerns, I would like to discuss briefly the innovation process and the financing requirements of the process.

Technological Innovation as a Process

Technological innovation is a high-risk time-consuming process; it is also a process which at different steps requires different levels of resources.



To illustrate, I find it useful to think of the process of technological innovation as a "pipeline". This aids our understanding of the resource requirements needed at different points in the process, and assists us in our efforts to devise effective policies to improve each step of that process. The pipeline concept highlights the fact that technological innovation is a continuous process that requires the complex interplay of many factors including government policies. It allows us to identify weaknesses in different stages in the process, and to isolate to some extent the implications of, or need for, governmental action.

In general, innovation can be considered to occur in three major stages. Stage I is the invention. This stage consists of new concept generation and technical feasibility assessments. The U.S. currently invests about $12 billion annually in this fundamental pool of knowledge. In absolute terms, this is many times more than any other nation invests. We therefore start with an advantage over other countries. But whether our head start becomes a competitive advantage depends upon how we handle the later stages of the innovation process. Stage II consists of translating the invention into a prototype product or process. The major share of the cost, the risk, and the time associated with innovation occurs during the second stage. We believe U.S. performance is not as good as it should be during the second stage of

innovation. Stage III is the successful commercialization of the new product. Commercialization involves considerable though reduced risk and often requires major capital investments. Government's role diminishes sharply as basic research moves into the commercialization stage.

The role of small business in all three stages of the innovation process is noteworthy. The major contribution of small businesses to technological innovation is seen by the many new products which are brought to market by small start-up companies. The ease with which these companies can be formed, grow, fail, or be absorbed is one of the most flexible and important elements of the American innovation process.

On average, it takes seven to ten years to move a significant new product or process from the idea stage through this pipeline. Perhaps one of twenty projects that starts out in the laboratory ever produces a positive cash flow. Innovation, therefore, entails high levels of risk. Since much of the basic R&D that is done in the United States is funded by the Federal government, we must give particular attention to the range of incentives, both private and governmental, that are needed to translate the basic discoveries into useful products or processes. For the pipeline to work properly, we need to remove barriers to its

successful operation and provide incentives that will stimulate risktaking.

Funding for Technological Innovation

This Administration has taken a number of steps to enhance productivity growth and to encourage industrial innovation. Several have increased the availability of funding for innovation. Notably, the Economic Recovery Tax Act of 1981 provides a 25 percent tax credit on incremental R&D investment. By reducing inflation and interest rates the President's economic program has also slowed the growth of research costs. Nevertheless, some studies suggest that the cost of capital in the United States still remains higher than that in other countries. To the extent that this is the case, U.S. investors in high risk long-term R&D stand at a disadvantage relative to our foreign competitors.

A continuing part of the Administration's efforts to foster innovation has been the identification of specific problems in financing the innovation process. One such problem is the inability of start-up businesses to take advantage of the R&D tax credit. The Administration supports Congressional efforts to remedy this situation. In this regard, the Administration supports section 882 of the Deficit Reduction

Tax Act, which would allow certain start-up corporations to obtain the R&D tax credit.

Research and development limited partnerships (RDLPs) may have the potential to partially fill this financing gap. The RDLP is a type of business organization that can be used to form syndicates to raise capital for research and development. As such, the RDLP is an alternative to in-house funding of R&D or to venture capital financing. The source of the bulk of the capital raised by RDLP's is the investments of individual investors, or limited partners. The limited partners are primarily seeking the eventual benefits of successful research. The potential of the RDLP can be seen by its rise, from perhaps $100 million in funded research in 1980 to nearly one billion dollars funded in 1983.

The Commerce Department has recognized the potential of RDLPs, and is encouraging their formation through the activities of the Industrial Technology Partnership Program. We have produced extensive documentation on RDLPs and how they can be established, including one document which has sold about 2000 copies through NTIS called Information and Steps Necessary to Form RDLPs. RDLPs are unique in that they are equally available to small or large, growing or declining companies. Also, the entrepreneur can recapture

equity ownership when the business is successful, if he wishes. This is a major incentive for new business development. In addition, the new Small Business Technology Liaison program of the Office of Productivity, Technology and Innovation is helping small high technology businesses to gain access to new technology developments and an understanding of funding options, including RDLPs.

In closing, I reemphasize the wide-spread benefits that any investment in new technology provides. The application of new technology is essential to increase productivity, to increase real income, to create new jobs, and to help control inflation. The bottom line, however, is that without increased innovation, many U.S. businesses will no longer be competitive in world markets and will continue to lose market share. We consider the promotion of technological innovation to be central to the national interest.

Thank you for the opportunity to participate in these hearings. I will be pleased to answer any questions.

Dr. MERRIFIELD. I really would like to make two particular points. One is that the world now really is technology driven, much more than we realize, and increasingly competitive, and the United States really cannot be competitive in this world without continual leadership in innovation.

The second point—and I would like to elaborate a little bit more on this later—is that R&D is such a powerful factor, it has greater leverage than any other factor, in creating new jobs, particularly in small business areas and in agriculture, in increasing productivity which brings down inflation, in generating new tax revenues which will bring down the budget deficit, in generating export sales to restore the trade balance, and of course in the reestablishing U.S. industrial leadership and maintaining that leadership and an increased quality of life here in the United States.

Let me just expand a little bit on both of those points.

I think that We have to understand that the life cycle in most products and processes is telescoping very rapidly. In electronics it is 3 to 5 years now; in most other things it will be 5 to 10 years, and it will be continually decreasing. As a result, the most important thing I think that the U.S. Government can do is to provide incentives and remove barriers to innovation.

Innovation increases productivity, which is one of the few constructive ways to bring down inflation and hold down inflation. Of course, it creates many new jobs.

We now have a bottom-up entrepreneurial revolution goin on in this country. We are now creating new jobs at the rate of about 5 million a year. In the last 10 years we have created something like 20 million new jobs. Almost all of these have been in small business areas. The Fortune 1000 actually has had a net decline in jobs over that period.

Innovation of course is one way that we can maintain our competitiveness, let alone leadership, in world markets when other nations are targeting our industries and capturing markets with cheap labor and cheap natural resources.

Above all, innovation leads to increased revenues and taxes that are the most effective way to reduce the budget deficits.

I think the leverage factor here is so great that we must realize how important it is then to create the incentives that allow it to happen.

From the Pims Data Base, which is a data base that includes confidential data on about 2,000 different companies in the United States, every dollar of R&D generates, on average, more than a 30-percent return on investment. Each R&D dollar eventually returns something like $20 in new sales and results in $5 to $10 of new taxes to the Government. I think this is an important thing.

Alternatively, failure to invest in R&D for any technology-dependent company is basically a decision to go out of business in 5-10 years, with of course a consequent loss of tax dollars and the demise of jobs and facilities. Unfortunately, this has been a not infrequent syndrome in many of our smokestack industries.

It seems to me that the Government role in this area should be as noninterventionist as possible in providing incentives, and I think that tax incentives in particular are the least interventionist of all incentives. The R&D limited partnership—that you may be

aware we have been developing—is perhaps one of the most effective ways to do this because it is equally available to declining industries as well as growth companies.

There are other mechanisms for funding and providing incentives, but I really just want to emphasize again not only that it is important to remove barriers such as antitrust and other regulatory barriers—and we have been putting an awful lot of effort into that—but also it is equally important to provide incentives for the process of innovation. Incentives provide tremendous leverage and, of all factors, can help us more than anything else in recapturing and maintaining world leadership in every area of industrial concern.

Thank you, and I would be happy to answer any questions.

Senator GRASSLEY. The first question I would like to ask is: What types of financial mechanisms in the Tax Code do you think should be used to finance R&D?

Dr. MERRIFIELD. Well, there have been a number of different suggestions from all sorts of private-sector sources; one of course is increased tax credits. The 25-percent R&D incremental tax credit has been available, but it is only allowed for companies that have been in business for 3 years. It is not currently allowed for startup companies or for new ventures or for R&D limited partnerships.

One of the suggestions that has been made is to make that permanent, of course—it expires in 1985 or 1986—and also perhaps to allow it for new ventures that would permit new developments in the innovation pipeline to come along more effectively.

Other suggestions have been for direct funding and guaranteed government loans, but unfortunately they carry a lot of bureaucratic redtape and political interference with them. I think they are much less attractive.

Of course the other area that has been suggested is reduced capital gains. I think the California model is an interesting one that has been developed. Basically, they reduce capital gains to zero for small companies—less than 500 employees—if those are held for 3 years or more.

Another thought that has been suggested is that taxes on capital gains be indefinitely deferred as long as they are plowed back into more R&D.

Those are interesting concepts. I think that they merit additional study and consideration, and we would certainly be happy to work with you and the Treasury in identifying the pros and cons of these options.

Senator GRASSLEY. Have you had a chance to consider the impact of depreciation schedules on the productivity of small business particularly, as to whether or not they ought to be changed, and particularly in relationship to the existing schedules that were set up in the 1981 Tax Code?

Dr. MERRIFIELD. That's a good question. Yes, investment tax credits and rapid depreciation allowances I think have been more effective than has been generally apparent. The TEFRA modifications in 1982 have mitigated those advantages, particularly in some companies—high technology companies—where technology is moving rapidly, and obsolescence of facilities has been progressively accelerated.

Rapid obsolescence is really the wave of the future, and we have to understand this. I think our tax codes have had in mind the model of the smokestack industries, where we have had anywhere from a 20- to 50-year life for products and processes in the past, and those are no longer relevant. When you telescope the life cycle of a product or a prccess to 3 to 5 years, or a maximum of 10 years, it becomes important that tax codes reflect that reality in the real world. The important thing to understand is, that we are in a changing period now, which has never happened before in history. This is a new period, and we must understand that we have to adapt our Tax Code to the reality of a very rapidly changing situation.

Management, by definition, will be the management of continuous change, and our tax codes, I believe, should reflect that.

Senator GRASSLEY. Let's suppose that we were to switch to a value-added tax or a national sales tax or a gross income tax, or a consumption tax, or something you might refer to as an alternate tax system. And I mean switch as opposed to a supplement to it.

One of the things we have been looking into in this committee is how would the transition from one to the other affect productivity of small business, if at all?

Dr. MERRIFIELD. Well, that's a good question. I am not sure that I am competent to answer it. There are some very interesting aspects that I have been following, but would take some rather extended study to evaluate.

There are certainly some very attractive positive advantages to some of those ideas. I am not sure, though, how best it would be to introduce such changes without some drastic consequences.

So although I think basically it is a very positive approach, and it is something we need to do, but it will take some additional study. I am not necessarily the most competent person to do that.

Senator GRASSLEY. All right.

I think your response might be geared toward the end product. Do you see any particular problems in the transition, assuming that you could move from 1 year to the other—which may be doubtful? But even if you could do that, or maybe it would take a 2- or 3-year transition period of time, in that short or longer period of time do you see any particular problems? Or were you addressing that as well in your previous comment?

Dr. MERRIFIELD. I was. I think there might have to be some special exceptions made in certain areas to allow that transition to occur. I am thinking in terms of the incentives that are now in place that are very constructive.

Again, from an innovation point of view, you have to understand that innovation is not an instantaneous event; on average it takes 7 to 10 years for an idea to become commercial, and only 1 out of 20 things that start out in a laboratory ever produces a positive cashflow.

So incentives that are addressed to that high-risk long-term process, if altered in midstream very abruptly, could have very significant effects.

So I think that we need to understand the process of innovation and the need for continuous innovation in addressing these changes.

That's about as much as I could say about it, I think.

Senator GRASSLEY. But implicit in your statement is that you do perceive problems, and that it is not a case of smooth transition necessarily.

Dr. MERRIFIELD. That's correct. And yet the advantages of a value added tax are tremendous, and the important thing, is to identify the least destructive way to make those changes. I think that we need to pool a lot of our thinking in order to do that most effectively.

Senator GRASSLEY. Is tax policy central to the area of research, development, and innovation? Or is it kind of a secondary management decision? In other words, does the Tax Code drive research and development? Is there a direct relationship, or is it a very secondary matter, and does the economics of the end product of the research and the, economics of that decision stand by itself?

Dr. MERRIFIELD. That's a good question. I think that the Tax Code can be a powerful force in stimulating innovation.

We have to understand that the cost of capital services, according to George Hatsopoulos is maybe 18 percent in this country; 7 percent in Japan. Certainly it is much higher here than it is in other countries.

A high cost of capital service is a tremendous deterrent to anything that is high risk and long term. Any investment in any high-risk and long-term operation is going to be deterred by the high cost of capital services. A reasonable return on investment is just out of the question when the risk is great.

For example, if you have something even at a pilot plant or a prototype stage with a one chance in two that it will ever produce a positive cash flow, and the cost of capital service is something like 18 percent, you are going to have to be looking for products and processes that have an ultimate potential of a 50-percent return on investment to justify that kind of investment.

So it is important that we neutralize that disadvantage that we have worldwide now that, if we are going to take advantage of our incredible pool of advanced technology in this country.

You see, we have an extraordinary advantage here. We have put about $12 billion a year now into the fundamental pool of knowledge in this country. That is many times more than any other country does or can do. And yet we don't utilize that effectively because those are early-stage developments that may take 7 to 10 years to translate into useful things.

Well, that sort of investment is high risk and long term, and when capital services costs are so high it's a severe deterrent to making such investments.

That's why the Tax Code can be a very important factor in mobilizing the tremendous assets which we alone have and we alone can maintain.

Senator GRASSLEY. Have you thought, then, if there is an economic inefficiency to basing a management decision on research and development and innovation from a Tax Code perspective as opposed to from pure profitability in isolation of any tax code?

In other words, we are making decisions based upon the Tax Code as opposed to upon the economic efficiency of our investment.

Dr. MERRIFIELD. That hasn't been too clear, but it in fact has been a factor.

Again, the reason why so much short-term R&D has been done in this country, particularly in the smokestack industries, that has recruited in those industries becoming obsolete or obsolescent has been the high cost and high risk of investment with no certainty of success. As a result, we have seen a decline in many of our smokestack industries, and we are no longer world competitive in those areas, although the technology has been there and has been developed by other countries with subsidies.

So there is no question that differences in the costs for R&D have had a deterring effect on maintaining our competence in these areas. There is no reason why the United States could not be and should not be and will not be the innovative leaders in almost any area of commercial enterprise. But at the present time we really have this deterrent, which is a very serious one.

Senator GRASSLEY. Well, have we tried to separate, in regard to considering the productivity and competitiveness of America versus some foreign competitor, the impact of the Tax Code in the respective countries as opposed to the Tax Code in the foreign country along with the normal encouragement that businesses in foreign countries get from government that our Government doesn't give to businesses outside of the use of the Tax Code?

In other words, we limit our incentives, I guess, basically to the Tax Code. We don't have a great deal of subsidy of our foreign trade through the Government; we don't have a lot of our own investment in research, except maybe through the defense industry. Most of it comes through the Tax Code. Have we considered the relationship?

Dr. MERRIFIELD. Well, yes, indeed. And that's a good point. The disadvantages we are working under are that, first of all, other nations do target industries and do subsidize in various ways. That is a disadvantage to us, because, for example, our antitrust laws in the past have prevented our companies from collaborating on an equivalent scale of effort. Not even an IBM can be competitive with a whole nation that is targeting its business.

Also, in addition to that, the underdeveloped countries are now taking market share with cheap natural resources and cheap labor, and those are very significant advantages over our business areas.

However, I am not in favor of targeting. I think that the Japanese have demonstrated that it is a very dangerous thing to target; they are now in big trouble. They may have the best steel technology in the world, but they are operating maybe at 60 percent of capacity, losing money on every ton they are making. They are operating at maybe 30 percent of capacity in aluminum, 50 percent in commodity petrochemicals, and shipbuilding, and textiles, and shoes, and so forth. They owe all of that money to the bank. Those industries now have been overbuilt in capacity worldwide. No one can break even in those industries until they are rationalized down. The targeted industry strategy is a zero-sum destructive game that destroys industries, and it is something we have to abandon.

Our forte is not to do that. In fact, if you want a good example of why a bureaucracy should never target, the Japanese are the

living, breathing model. And we don't need to rediscover that wheel here in the United States.

Our advantage is in the tremendous advanced technology pool that we have that we will continuously maintain, and in the opportunities to provide incentives for effective utilization, of that pool.

I think we can outrun anybody, any time, any place, if we just get our act together. And that's the key thing, getting barriers out of the way and providing incentives, but not in interventionist ways, so that we can preserve the incredible creativity and productivity of the private sector.

We have it in spades. We have an entrepreneurial culture that is absolutely unique, and whenever the incentives are put in place a tremendous explosion of new things begins to happen. It is a marvelous thing to watch this.

I am in touch with this as I scan several thousand new companies that are forming each year. You can't believe the creativity and the ingenuity that is involved there.

The R&D limited partnership has been particularly effective in stimulating small businesses; in fact we had maybe $1 billion of those formed in the last couple of years and maybe $2 or $3 billion this year, just with the present state of that incentive.

Again, I would emphasize that we don't want to target, we can't compete with cheap labor and cheap natural resources; but our basic advantage is in our advanced technology.

Senator GRASSLEY. I can tell my last question was too long. The main point of my question was this: I want to take the normal subsidy and the targeting that foreign countries do more of than we do—and I guess I would argue that we don't do it at all—and set it aside, and then just consider whether or not there has been any research on the impact of the Tax Code in foreign countries, on the competitiveness and the business decisions of the entrepreneurs and business managers in foreign lands, compared to what that Tax Code impacts upon a business decision in this country.

Dr. MERRIFIELD. Well, I understand. And the point is that basically the tax incentives, or tax advantages, or what we call "forms of subsidy" in other countries, have tipped the balance away from us. And our systems have not adapted equally. Therefore, we are at a disadvantage at the present time, to some degree. What I am suggesting is that that could be dealt with.

Senator GRASSLEY. Then maybe the point I don't understand is, is the Tax Code in the foreign countries, is that central to the targeting and central to the export subsidy? Because if it is, then it is an integral part of the overall problem, and I was trying to separate it out of the overall problem of targeting and direct subsidy as opposed to indirect subsidy that comes through the Tax Code.

Dr. MERRIFIELD. Well, it certainly is not an insignificant part, but it is only a part.

You see, for example, just to give you the model, the targeted industry strategy starts with targeting the industry, collecting the players, throwing out the little ones or merging them in with the big ones, and concentrating the business in the home market.

The second step is to parcel out R&D among the remaining players to avoid redundant effort.

The third step is to leverage those results 80 to 90 percent with low cost—4 or 5 percent—capital.

The fourth step is to close off the home market to imports, to further base load economies of scale there.

The fifth step is to two-tier price. And I won't go into that.

The sixth step is to manipulate the exchange rate.

And the seventh step is to have export subsidies.

So in a sense the tax incentives are there, but they are only one of about seven different factors involved in targeting. The combination, though, makes it noncompetitive for us in given industries where collaborative efforts have been deterred by antitrust and other regulations, and where we have not had equivalent incentives.

Senator GRASSLEY. Well, Dr. Merrifield, I appreciate your speaking as an individual and also for the administration, as an Assistant Secretary in the Department of Commerce.

I would hope that, as this is an ongoing discussion and we still have other hearings scheduled on this very subject, you would keep in touch with us so that we could have a further refinement of your testimony, and particularly we might ask you to zero in on some of the more specific points that we have, as we intend to in the future, impact upon this committee's consideration of the Tax Code and productivity toward the end of making more productive our economic base through business, agriculture, and large corporations.

Thank you.

Dr. MERRIFIELD. Thank you. I would be happy to do that.

Senator GRASSLEY. Our next witness is a panel of three. The first person to testify—and I would ask all of these people to come to the table at the same time—is Bruce R. Bartlett, vice president, Polyconomics, Inc., Norristown, NJ.

I first became acquainted with Bruce when he was executive director of the Joint Economic Committee.

Prof. William C. Dunkelberg will be here late. He is not here yet, at least. So we will just have two people on this panel.

The second will be John Motley, deputy director of Federal legislation, the National Federation of Independent Businesses. His organization, as everybody knows, has been very helpful to this subcommittee on many different subjects that we have investigated, but particularly we are interested in hearing the testimony of Mr. Motley and his organization because so many of the new jobs that have been created in this most recent economic expansion, about 80 percent of them—or at least two-thirds of them, I should say, but maybe as high as 80 percent—have been created in businesses that are the size that normally would be members of the National Federation of Independent Businesses.

I would ask you to start, Dr. Bartlett, and then we will go to Mr. Motley.

STATEMENT OF BRUCE R. BARTLETT, VICE PRESIDENT, POLYCONOMICS, INC., MORRISTOWN, NJ

Mr. BARTLETT. Thank you very much, Mr. Chairman.

I will just summarize my statement.

The point about small business that I think is critical and the one that I emphasize in my statement is not the mere encouragement of small business for the sake of small business, but rather the encouragement of entrepreneurship; that is, the ability of individuals to be able to start a firm and run it as they see fit.

In my view, and I think in the view of most economists, innovation, entrepreneurship, risk taking, and things like this are generally stifled in large organizations. They require the freedom of action that comes from being able to own and run one's own business as one sees fit.

It seems to me that this aspect of small business, the encouragement of entrepreneurship, is the critical thing that we ought to be getting at.

The sorts of policies that I concentrate on in my statement are generally different than the sort of tax policies which most people talk about. I think that a lot of things that are enacted in the name of helping small business don't really help them as much as we might think they would.

I think part of the reason for this is the misunderstanding that, although they are businesses, most small businesses are not corporations—they are sole proprietorships. And we need to think of them in terms of the individual and the sorts of tax policies that impact on the individual, rather than the sorts of tax incentives which have tended to be enacted which are largely beneficial to corporations. They tend also to be helpful only to large established firms.

Let me give you an example of what I am talking about. The investment tax credit is the most important aspect of the Tax Code as far as helping business. It was enacted largely because it was felt by President Kennedy when he proposed it that the people wouldn't support a general reduction in the corporate income tax; although almost every economist I know of thinks that the corporate income tax ought to be abolished and fully integrated with the individual income tax.

In lieu of not being able to do anything about this, they enacted this tax credit. Well, the tax credit requires you to have profits, and therefore tax liability to use it against. A small firm that is just starting up is probably not going to have any profits for some years. So, to the extent they get any benefit out of the investment tax credit, they have to carry these benefits forward for years and years and years. In this sense, therefore, the investment tax credit is not a neutral sort of tax. And I think it generally serves the purpose of helping large firms and not helping small ones at all.

There are other things in the Tax Code that I think people don't usually think about when they think about small business. I think the estate and gift tax is an important tax that hurts small businesses, because one of the prime motivations of starting and running a small business is to be able to leave some legacy to one's heirs, and therefore this tax impacts more on people's investment decisions than I think people imagine it does. It is really a tax on labor and a tax on capital.

The capital gains tax is also significant. The reduction in this rate was, I think, the primary instigator in getting the venture capital, small business, high-tech bandwagon going, and this started in

1978. I really worry about where we would be today in terms of international competition if we had not taken that action. And yet at the time, as I am sure you remember, the administration was opposed to this change.

So in the end of my statement I list five measures which I think would be helpful:

One would be the elimination of the investment tax credit and a reduction in the corporate tax rate of an equivalent dollar amount, so this would be revenue-neutral. I think this would help smaller firms greatly and stop subsidizing large firms for investments that they are probably going to make anyway.

I think we need to allow full deductibility of capital losses against ordinary income. As you know, right now an individual can only deduct up to $3,000 in any 1 year of capital losses, and he can only carry these forward not backward. I think that full deductibility is desirable.

I think that, ideally, the capital gains tax should be abolished. But in the interim I suggest that we at least reduce the holding period to zero and index capital gains as well.

I think individuals ought to be allowed to have rollover accounts like IRA's in order to be able to accumulate savings, so that they can perhaps start a business if they want to.

And lastly, I suggest the abolition of the estate and gift tax.

I will be happy to elaborate on these points afterwards.

[Mr. Bartlett's prepared statement follows:]

Statement

by

Bruce R. Bartlett

Polyconomics, Inc.

before the

Subcommittee on Oversight of the Internal Revenue Service

Committee on Finance

U.S. Senate

May 21, 1984

Mr. Chairman, it is a pleasure to appear before you today to discuss ways in which tax policy can be reformed to aid small business and raise productivity.

In my view, a strong and vibrant small business sector is essential to the long term growth and well being of our economy. Large firms, as important as they are to the economy, are not the principal sources of innovation and invention. By and large, it is still the individual entrepreneur who is the sparkplug of the economy, the one who gives it its dynamism and vitality.

Entrepreneurship is generally stifled in large organizations. Above all, it requires freedom of action to thrive. And the greatest possible freedom comes from owning and running one's own business. Hence, it is critical that the ability to start and run a small business be preserved and strengthened, so as to allow entrepreneurship to flower.

Resistance to change is a natural aspect of human nature and the entrepreneurial function is, above all, one of bringing about change: creating new products, finding new markets, discovering new ways of doing things. Invariably, therefore, there are barriers to the new and different. It is so much

easier to just keep doing things the same way. Consequently, governments and financiers are reluctant to approve or finance new projects, being inclined more to supporting the tried and true.

Thus, even under the best of circumstances, life for the entrepreneur is difficult. To nevertheless act in the face of such obstacles and overcome the resistance requires exceptional traits and attitudes present in only a tiny fraction of the population. With entrepreneurs being such a scarce commodity, we can ill-afford to discourage them. Instead, they must be nurtured and encouraged.

Unfortunately, government policy is largely geared toward suppressing invention, innovation, and entrepreneurship, rather than stimulating it. Too often, burdens are placed on business which--though their impact on large, well-established firms may be small--have a devastating effect on small, recently established firms. At the same time, government enacts incentives that tend to enhance the profitability of the former while little, if any, stimulus is given to the latter. The result is a stifling of creativity, stagnation, reduced competition, loss of market shares to foreign companies, and declining productivity. It also gives rise to a

false belief that capitalism itself is flawed, leading to further pressure for government intervention.

Let me now turn to ways in which tax policy is biased against small business and discourages innovation. I would just mention that government regulations, spending and monetary policy also impact on small business as well.

The most important thing we need to understand about how tax policy impacts on small business is that it is the individual income tax, not the corporate tax, with which we must be most concerned. When one thinks about business taxes one tends to think mainly about the corporate tax. But the reality is that the vast majority of businesses in the United States are either sole proprietorships or partnerships, not corporations. In 1980, according to IRS data, there were 12.7 million proprietorships in the U.S. and 1.4 million partnerships which filed tax returns. By contrast, there were just 2.7 million corporations. This means that the individual income tax law is of vastly greater significance for most businesses than the corporate income tax law.

The significance of this fact is that the personal income tax is steeply progressive and the highest individual income tax rate exceeds the highest

corporate tax rate. Although the gap is not as wide as it was, it is still significant. Also, there are many features of the corporate tax which are far more generous than those available to individuals, such as being allowed to carry back losses. The result is that the individual income tax is more punative to entrepreneurs when they do "strike it rich."

Consequently, taxes make it excedingly difficult for small businesses to internally generate the capital needed to grow. It is no coincidence that Henry Ford built the Ford Motor Company into one of the major companies in America during a time when the income tax was nonexistent or very low by today's standards. He could therefore afford to plough his profits back into the firm year after year without sharing half with Uncle Sam.

When small firms cannot grow into large ones one effect is to allow large firms to become complacent, as the threat of competition from below is diminished. Thus the economy suffers in ways which are very hard to see because they involve new products which are never manufactured, innovations which don't take place, and prices which are higher than necessary. Let me quote the great economist Ludwig von Mises on this point:

"Every ingenius man is free to start new business projects. He may be poor, his funds may be modest and most of them may be borrowed. But if he fills the wants of consumers in the best and cheapest way, he will succeed by means of 'excessive' profits. He ploughs back the greater part of his profits into his business, thus making it grow rapidly. It is the activity of such enterprising parvenus that provides the market economy with its 'dynamism.' These nouveaux riches are the harbingers of economic improvement. Their threatening competition forces the old firms and big corporations either to adjust their conduct to the best possible service to the public or go out of business.

"But today taxes often absorb the greater part of the newcomer's 'excessive' profits. He cannot accumulate capital; he cannot expand his own business; he will never become big business and a match for the vested interests. The old firms do not need to fear his competition; they are sheltered by the tax collector. They may with impunity indulge in routine, they may defy the wishes of the public and become conservative....In this sense progressive taxation checks economic progress and makes for rigidity."

Congress has not been oblivious to the tax burden on business. Over the years many special features of the tax code have been enacted specificially to aid business. Unfortunately, because it has not recognized the critical role of individual entrepreneurship in our economic system, Congress has tended to concentrate its tax benefits on large corporations, rather than small businesses. This results from the fact that most of the important tax incentives for business in the tax code are designed to aid capital formation. The investment tax credit and accelerated depreciation are the two most important measures in this respect. In addition, large firms can more easily afford the high-priced lawyers necessary to figure out other features of the tax code, such as DISC and the foreign tax credit, which are too complex for small firms to master. Thus, although such items as the investment tax credit and the foreign tax credit are potentially available to all businesses, in practice the major portion of their benefits go to just one tenth of one percent of all corporations.

Generally speaking, small businesses tend to be labor intensive while large ones tend to be capital intensive. Thus measures designed to aid capital formation are generally of considerably less value to

small firms than to large ones. This is especially true when you consider that a business just starting up will probably not have any profits for several years to use the investment tax credit or other tax incentives against. Consequently, most small firms get no value out of the investment tax credit whatsoever.

At the same time one can argue that the major effect of the investment tax credit is not to stimulate capital formation, but rather to lower the tax liability of large firms. Although some investments are made because of the credit which would not otherwise be made, the investment tax credit cannot distinguish between such investments and those which would have been made anyway even without the credit. Thus, a great deal of the benefits of the investment tax credit are simply rewards to firms for doing what they would have done even without the investment tax credit.

Another aspect of the failure of policymakers to understand that small firms are mainly labor-intensive sole proprietorships is that they have not understood the important impact of such things as the social security tax on small business. This tax is a direct tax on labor. Because, as I mentioned, small businesses tend to be labor intensive, this tax hits small firms much harder than large ones.

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At this point let me just briefly mention several other aspects of U.S. tax policy which I feel discriminate against small companies:

The Capital Gains Tax. The impact of this tax on small firms is well-known. Small firms just starting up are not going to have profits or dividends to pay out to investors for some time. But, if they are successful or have good prospects, the value of their assets may rise sharply. Thus, in terms of inducing investments in small firms the capital gains tax is the most important one for venture capitalists.

The story of how the 1978 capital gains tax cut stimulated venture capital investment and entrepreneurial activity is already well known to this committee. But the numbers are nevertheless worth repeating: In 1977 there were exactly 2 initial public offerings of stock in the U.S. After the capital gains cut, however, they skyrocketed, reaching 304 last year. In terms of venture capital, 200 times more such capital was raised last year than the average for the years 1970 to 1977. New business incorporations have soared from 280 thousand in 1978 to over 600 thousand last year.

In my view, and the view of most experts, there is no question that this outpouring of entrepreneurship is a direct result of the capital gains cut.

Estate and Gift Taxes. These taxes are far more harmful than is generally known. The reason is because it is a direct tax on capital. It is also far more of a tax on labor and entrepreneurial activity than most people imagine. Professor Richard Posner of the University of Chicago Law School, and now a federal judge, makes this point well when he said: "Since the accumulation of a substantial estate is one of the motivations that drive people to work hard, a death tax is indirectly a tax on work."

It takes a long time to build up a small business into a large, profitable one. Many entrepreneurs know full well that most of the benefits of their effort may not appear until after they are dead. But they continue to work hard nevertheless because they want their family to be better off. However, if they thought that the taxpayer would be the major beneficiary of their effort--even if it is after their death--it could have a major impact on an entrepreneur's willingness to work and sacrifice during his working life. With entrepreneurs being such a valuable resource, this is something which should concern us.

Tax Treatment of Interest. Under U.S. tax law, most interest paid is fully tax deductable, while

most interest earned is fully taxable. The effect of this, as one might imagine, is to encourage borrowing and discourage saving. This is important for small business for two reasons: Most small businesses don't have the same access to borrowed funds as large firms do. They must raise their capital through equity or private saving. Unfortunately, the tax on interest makes it very difficult to accumulate savings. The effect of this on entrepreneurial activity has been eloquently described by the British economist, Lord Robbins:

"The fact that it has become so difficult to accumulate even a comparatively small fortune must have the most profound effects on the organization of business;...Must not the inevitable consequences of all this be that it will become more and more difficult for innovation to develop save within the ambit of established corporate enterprise, and that more and more of what accumulation takes place will take place within the large concerns which--largely as a result of individual enterprise in the past--managed to get started before the ice age descended?"

For these reasons I would agree with the conclusion of a House Small Business Committee report that "the practical effect of Federal tax policy has

been the tendency to encourage the growth of large firms at the expense of the small."

What can be done about this? Short of complete overhaul of our tax system--replacement of the individual income tax with a simplified flat-rate system such as the Kemp-Kasten proposal and abolishment of the corporate tax--I would suggest the following measures:

1. Elimination of the investment tax credit and a concomitant reduction in the corporate tax rate. This should allow for a six to eight percentage point drop in the corporate tax rate.

I believe that this proposal would eliminate much of the bias in our tax system toward big business and make the tax system far more neutral, and therefore more efficient. Henceforth, major capital investments would be made more on the basis of their fundamental soundness than on their tax consequences. It would also eliminate a major element of tax shelter arrangements.

2. Allow full deductability of capital losses against ordinary income. I think this would enormously stimulate entrepreneurial activity on the part of individuals and could have as positive an impact on the economy as the capital gains cut did.

3. Short of abolishing the capital gains tax--which I favor--I would reduce the holding period for capital gains treatment to zero. In my view, a capital gain is a capital gain and entitled to the same treatment whether the asset has been held for 1 year or one minute.

I would also index capital gains so that whatever tax is levied on capital gains taxes only the real component of that gain and not the inflation component. Since we have already indexed individual income tax rates I can think of no reason why capital gains should not be indexed as well.

4. To eliminate the tax bias against saving I would propose the establishment of unlimited rollover accounts. Money could be added or taken from this account at any time without penalty. At the end of the year net withdrawls would be fully taxable and net contributions would be fully deductable.

5. Abolish the estate and gift tax. This tax raises very little revenue compared to the damage it does to the economy. President Reagan promised to work for repeal during the 1980 campaign. I would urge him to follow through on that promise.

There are, of course, any number of other tax changes which could be proposed which would help small

business, and there are any number of non-tax reforms which are necessary as well. But I have tried to concentrate on those changes which I think are most essential from the point of view of encouraging entrepreneurship, innovation and risk-taking, because these are the qualities in small business which I think are most important.

STATEMENT OF JOHN J. MOTLEY, DEPUTY DIRECTOR OF FEDERAL LEGISLATION, NATIONAL FEDERATION OF INDEPENDENT BUSINESSES, WASHINGTON, DC

Mr. MOTLEY. Thank you, Mr. Chairman.

On behalf of NFIB's over 500,000 members I would like to thank you for the opportunity to appear here today and testify on this important topic.

What I would like to treat in my statement would be the impact on jobs by tax policy in this country.

Let me just, if I can, outline for you the important role that small business does play in the job-creating markets of the country.

As you stated before, approximately half of all of the jobs in this country are in the small business sector. In the last several decades there is a ream of new research indicating that most of the new jobs which are being created in the United States every year are coming from firms with under a hundred employees.

In this year's report by the President on the status of small business it is indicated that between 1980 and 1982 all of the net new jobs in this country came from firms with 20 or fewer employees, and that for firms with over 100 employees there was a loss of 1.7 million jobs during those 2 years.

The year 1983 was also a very good year for small business. According to NFIB's quarterly economic report on small business, the fourth quarter of 1983 was the best quarter we had for the creation of new jobs amongst NFIB's members in this country during its 10-year history.

I would like to digress for a second if I could and touch upon what the Assistant Secretary mentioned before, and that is the relationship between high tech or R&D and jobs in this country.

There is no denying the important role that high tech plays in the economy of this country today, and also in the state of this country in the international marketplace. But I do think that it is very trendy and attractive to attribute everything going on in the job creation area to high tech. I think there is a need for balance.

There is a need for balance in the thinking of the members of this committee and the Members of Congress. Congress has reacted since the mid to late seventies, and has done quite a few things to

encourage research and development, to encourage high tech industries, and they have done them generally in the name of small business. And yet there are many, many things out there that need to be done for small business that will help them get through and continue to create jobs.

Jobs are being created in this country in the services; they are being created in retail; they are not necessarily being created overwhelmingly in high tech and research and development; they are not being created in manufacturing.

So the problem I see is that every time Congress reacts to one of these trendy and very attractive things which comes along, while those particular firms may benefit, the firms on Main Street tend to lose. And it is a continuing cycle.

I would like to funnel my statement to four broad areas, other than just jobs:

One would be the impact of payroll taxes on job creation.

Second would be tax simplification.

A third, capital formation;

And last, very quickly, the notion of tax reform.

We at NFIB believe that payroll taxes are a time bomb which is ticking away in this economy. Most small firms, as you know, are labor-intensive. And as I mentioned before, most of the jobs which are being created in today's economy are coming from the service sector, the retail sector, and so forth.

In 1981, NFIB did a study with Touche-Ross of a group of members of ours in 17 different States across the country. We found out that of all of the members studied, they all paid more than half of their taxes in payroll taxes—their total tax bill. Most of them were as high as 75 percent of their total tax bill; some of them were as high as 90 percent. Now, that includes income taxes, property taxes, excise taxes, sales taxes, and whatever.

Over the last 25 years the amount of money collected to finance the functioning of the Federal Government through payroll taxes has roughly doubled. Today, fully one-third of all of the Federal Government's revenues comes from payroll taxes. We are tremendously concerned about this because of the labor-intensiveness of small business and because of the fact that there are payroll tax increases planned for every year for the remainder of this century, and probably beyond that as FICA and food continue to go up.

What really bothers us most is that payroll taxes are terribly regressive. They bear no relationship at all to the small business's ability to pay; 2 years ago during the recession we had small businesses who were losing money going out and borrowing it to pay their payroll taxes.

What really scares us about this whole thing, Senator, is that most of the programs that we fund through payroll taxes today—medicare, Social Security, unemployment compensation—are still in deep trouble. And all we foresee in the future, unless something is done, is continued rises in payroll taxes.

Let me make one comment on new businesses which was mentioned by the Assistant Secretary. I think taxes like payroll taxes have their most cynical effect in new and small businesses. New business comes into existence not making any money, it's operating on a shoestring trying to get through, and they have to pay 100

percent of payroll taxes, whether they are making money or not. Plus, if you take a look at unemployment compensation taxes, over half the States in this country experience-rate those small firms at the very highest level, until they gain some experience. It seems like the whole system is set up to prevent small businesses from getting off the ground.

Another thing which bothers us terribly is the attitude of conservatives—and I lump most small businessmen into this category—that payroll taxes are a necessary evil to retard the growth and enforce discipline in these socially related programs.

Well, Senator, if they have retarded the growth of Social Security and some of these other programs, or if they have enforced discipline in those programs, then I think that we need to go out and prove it some way. I think that whole attitude has been nothing more than a dismal failure.

I think we need, really, to take a look at the base upon which these programs are funded. We cannot continue to do this through payroll taxes, or else you will have a very serious problem of killing the goose that laid the golden egg and inhibiting small businesses from creating jobs in the future.

Very quickly, let me touch upon tax simplification. It is an important subject for small business.

Back in the late 1970's, NFIB surveyed its membership and found out that roughly a quarter of them did their own taxes. They did not go out and hire accountants and others to do it for them. Therefore, there are very few resources within the small business community to go out and hire the best minds in the country to figure out how they can avoid taxes. Because of that there is very subtle discrimination in the Tax Code toward small businesses.

Congress took care of one subtle form of subtle discrimination in 1981 with ACRS. Small firms didn't use asset depreciation range; so we simplified depreciation accounting, and small firms are able to use it now.

I would suggest to you that the same task needs to be accomplished in inventory-accounting rules, which are just as archaic and out-of-date as depreciation was.

You also need to take a look at paperwork. The Federal Paperwork Commission which was in existence in the 1970's indicated that 60 percent of the total paperwork burden for small business comes from the IRS. And that hasn't changed one iota, even with the passage of the 1980 Paperwork Reduction Act by the U.S. Congress—an act which I might mention has still not been reauthorized and was supposed to be reauthorized by March 31 of this year.

Capital formation. The Tax Code in this country is used for a myriad of purposes. You heard the Assistant Secretary mention the need to use the Tax Code to encourage research and development, to encourage high tech. It is used to enhance our position in the international marketplace. It is used to modernize industry. Well, if it is used for all of these things, why can't we use it to enhance job creation, entrepreneurship, and a healthy American small business community?

If tax policy is going to be used to encourage certain things, then we at NFIB think that small business should be at the top of the

list, because small business is extremely important to a healthy America.

One suggestion, one that we have proposed in the past, and that is of allowing a defferal on capital gains taxes on the proceeds of any asset which is sold, so long as it is invested in a qualified small business.

Again, the Assistant Secretary mentioned it before, that this should be done for R&D. We wouldn't stop at R&D; we'd make it possible for all small businesses across this country to share in that.

In conclusion, Senator, let me say just a few words about tax reform. It is in vogue right now, with an awful lot of comment going on in this town about it, especially. We hear about flat taxes, we hear about VAT's and national sales taxes and consumption taxes. Let me suggest that whatever the Congress decides to do, that they look very, very carefully at the impact of any tax reforms on the ability of small business to survive. And I will give you one example:

Probably the most talked-about tax reform item which is on the table today is Senator Bradley's fair tax—it has been out there for a long time.

Well, on the business side, the fair tax would set a 30-percent flat-rate tax on corporations. Today more than 50 percent of all corporations are paying the bottom rate—15 percent. And those corporations are generally in the service and retail areas; they don't have a lot of deductions or credits to claim. They are paying a very high effective tax rate already today, and the fair tax, if passed, would guarantee them 100-percent increase in their taxes.

So I would suggest that you and the rest of the committee take a very, very close look at all of the suggestions which come forward to make sure that they impact upon smaller firms carefully.

Thank you, Senator. I am sorry I took so much time.

[Mr. Motley's prepared statement follows:]

NFIB National Federation of Independent Business

The Guardian of Small Business

STATEMENT OF

JOHN J. MOTLEY III
DIRECTOR OF FEDERAL LEGISLATION

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Before: Senate Finance Committee, Subcommittee on Oversight of Internal Revenue Service

Subject: Tax Policy and Small Business Job Creation

Date: May 21, 1984

My name is John Motley, Director of Federal Legislation for the National Federation of Independent Business (NFIB). On behalf of the more than 560,000 small business members of the NFIB, I am pleased to have the opportunity to present the membership's views on tax policy issues.

Tax policy and the implementation of tax policy can have a severe impact on the ability of a small business to compete and survive in the highly competitive business climate of today. In long range terms, the most serious tax policy problem for small business results from poor economic policy. Economic policies which cause inflation and high interest rates result in distorted effective tax rates and distorted financing patterns particularly distressing to small business. While we will be

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addressing specific concerns of tax policy, it is not possible to ignore the effects which economic policy has on tax policy.

Small Business and Job Generation

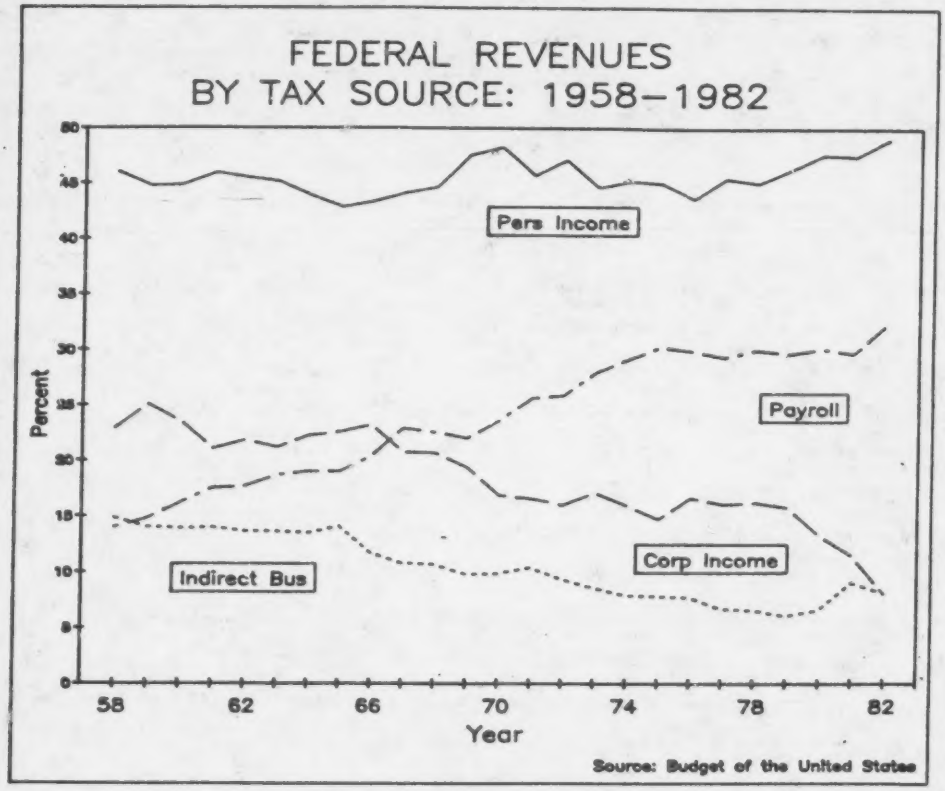
A direct result of Economics and tax policies harmful to small business will be a reduction in the ability of small business to generate new jobs. The loss of this job generating engine to the American economy would be devastating for data reveals that large firms have exhibited a net loss in jobs in recent years and that small firms with under 20 employees generated all of the net new jobs in the economy between 1980 and 1982. Over the same period of time firms with 100 employees lost 1.7 million net jobs. This stark fact was recently reported in "The State of Small Business, A Report to the President."

The reasons for this upsurge in small business jobs is in part due to the labor intensive nature of small firms and the tremendous upsurge in the formation of new small enterprises which require new employees. Even more encouraging was the fact that this dramatic growth in jobs was found in both traditional and nontraditional small business industries. It is out of a need and desire to encourage further job growth that tax policies which impact on small firms negatively, must be a concern of Congress.

Payroll Based Taxes

In the last 25 years, the percentage of federal revenues raised

through Federally imposed payroll based taxes has doubled and today a full one-third of all revenues raised by the federal government is in the form of payroll based taxes (see Chart 1).



A majority of small businesses pay more in payroll taxes than in any other form of taxation.[1/] It shouldn't be surprising, therefore, that small businessmen and women are very concerned about the current level of payroll taxation as well as its future course and rank it as one of their more serious problems.[2/] However, the small business interest in payroll taxes is considerably more subtle than the straightforward payment of a tax which often cannot be backward or forward shifted.

The primary problem for a small business is alteration in the competitive abilities of various firms. Some firms competitively benefit from payroll tax increases; some firms lose. As a group, small business falls in the latter class. The small business competitive disadvantage occurs for several reasons: (a) it has minimal "staying" power and cannot accept unprofitability for an extended period; (b) incentives toward leisure directly affect the availability of qualified labor; (c) payroll taxes provide incentives toward capital utilization, but capital costs for small business are relatively more expensive; (d) the deductibility of wage taxes from income taxes is less useful in the 15% bracket than in the 46% bracket; (e) the wage base provides a competitive advantage to higher wage (usually larger) businesses; and (f) small firms are more labor intensive that are large firms.

a. minimal staying power--

Small businesses have minimal "staying power." Most simply do not have the financial resources to withstand prolonged periods of

negative or very poor earnings. Thus, even if the full cost of the employer's share of payroll taxes can be backshifted or forward shifted in the long run, small business often can't reach the long run. The concern must be survival in the short run. But as has been demonstrated, in the short run increased fixed costs can't always be back or forward shifted. In those cases, the small business must directly absorb any payroll tax increase. Absorbing the increase makes the small firm less competitive and more vulnerable financially than it would ordinarily be.

b. availability of qualified labor--

The unemployment rate has hovered around 10%; people line up for blocks to apply for a few new jobs when a business or government agency announces employment vacancies. Yet, small employers constantly complain they cannot locate qualified employees; even at the depths of the '74-'75 and the '81-'82 recessions nearly one of ten small businessmen and women reported at least one current job opening.[3/] Something just doesn't seem to make sense.

Small businesses, as a group, do not compensate (including benefits) their employees as well as do larger firms. They simply cannot afford to and still remain competitive. So, small businessmen and women often pay the price through "in-kind" contributions, more specifically job training. It has been estimated new labor force entrants receive an average of $6,500 worth of training from their small business employers. However, the

value of job training is not part of immediate take-home pay.[4/] And as has been noted earlier, it is take-home pay that young and generally less-skilled workers, precisely the labor pool upon which small business must rely, are highly sensitive to in making labor force participation decisions. Payroll taxes, to the extent they serve to reduce wages, therefore, result in a greater impact on those employers who employ labor sensitive to take-home pay and in a lesser impact on those employers who employ labor insensitive to take-home pay.

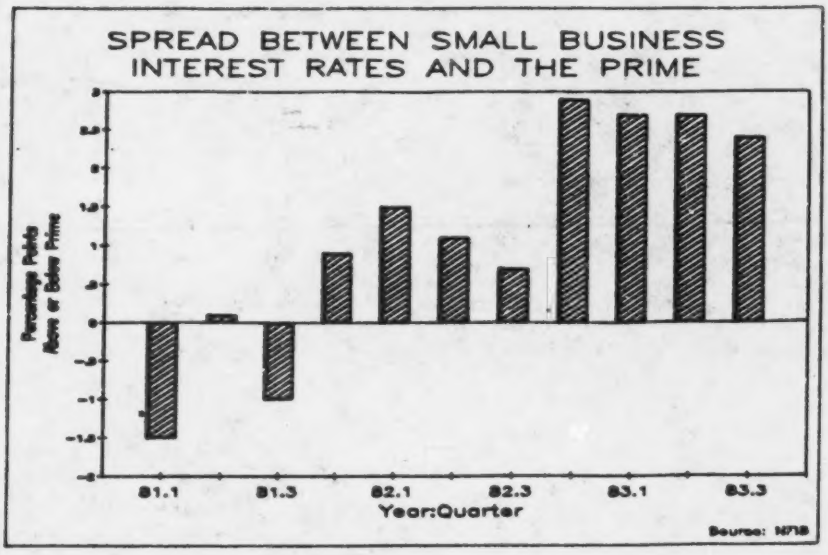
c. greater cost of capital--

One of our sustained economic myths is that small businesses pay 3-4 percentage points above prime for their debt capital. While exaggerated, the point of the myth, namely that small business pays relatively more for its capital than large business, is accurate.[5/] Not only do direct borrowing costs tend to be somewhat higher for smaller firms, but alternative financing mechanisms such as commercial paper are the exclusive domain of the largest firms.

Chart 5 illustrates one aspect of the capital cost problem. Assuming large businesses on average receive the prime rate, the cost of borrowed capital provides small business a competitive disadvantage. Note the difference between average prime and average small business cost on short-term loans is about 1%-3% over the period. While the volatility in the financial markets has resulted

in a continually fluctuating quarterly spread, the cumulative effect is about the same.

Chart 5



If payroll taxes raise the relative costs of labor and lower the relative costs of capital, capital becomes more cost-efficient to use. However, small business is at a competitive disadvantage whenever it procures relatively expensive capital. The result is a "Catch-22." Small business must either choose labor to its competitive disadvantage with those choosing capital, or it must choose capital to its competitive disadvantage with those procuring capital more cheaply.

d. deductibility from income tax--

Graduation in the Federal corporate income tax was permanently codified in 1978 (prior to that time it had been "temporary") in part to equalize the effective tax rates of larger and smaller corporate taxpayers.[6/] While certainly very desirable from the small business perspective, its perverse effect was to raise the relative cost of payroll taxes to small firms. For example, if two firms each had $100 in payroll tax expenses and one paid income tax at the 15% rate while the other paid the 46% rate, the latter firm would clearly find any increase in payroll taxes a competitive advantage. Since an original purpose of establishing the rate differential was to equalize effective rates, every payroll tax increase erodes the graduation's intended effect.

e. wage base--

The wage base provides those businesses with relatively highly paid employees a competitive advantage. The advantage arises because the tax is paid on a lower percentage of total payroll. However, the problem has increasingly become a function of the FUTA rather than the FICA wage base. Over the past decade, the FICA wage base has risen more rapidly than the wages on which it applies. The result has been a substantial reduction (estimated at .629% of payroll in 1971 to .170% of payroll in 1979) in the advantage of larger firms.[7/] The same is not true of FUTA, however.

The Federal FUTA base is $7,000. While most states utilize that figure as well, nineteen have higher bases, with the largest in the continental U.S. being Utah at $14,800. Table 2 provides the distribution of employees by firm size and wage class. Observe that the FUTA wage base is such that the percentage of payroll covered is considerably higher for small firms than for larger ones. A minimum of 3/4's of employees in large firms exceed the Federal FUTA base, for example, in contrast to 2/3's of employees in small firms who exceed it. Whenever there is a difference in wage structure (as differentiated from income or compensation structure), one group of firms will receive a competitive advantage from an across the board tax rate increase.

Table 2

Distribution of Employees by Firm Size and Wage Class--1930

Annual Wages	Small Business	Large Business
under $10,000	29.9%	16.9%
$10,000-$20,000	46.5	49.1
over $20,000	20.0	36.6

SOURCE: SBA

f. labor intensive--

The final reason for competitive alteration caused by payroll taxes lies in the labor intensive nature of smaller firms. Table 3 has been developed from data found in Social Security: A Tax on Labor produced by SBA's Office of Advocacy.[8/] Observe that small business is more labor intensive than larger firms when measured by either payroll as a percent of sales or OASDI taxes as a percent of sales. Both indicate the existence of about a 15% difference.

The curious part of Table 3 is the industry by industry comparison. Note that large firms are significantly more capital intensive than are small firms in the mining, manufacturing, and wholesale sectors. In retail and service, small firms are marginally less labor intensive than large firms, and in the construction industry they are considerably less so. It is not surprising that in the former three industries, small business has been and is losing market share rather rapidly; in the latter three industries, small business remains a vibrant force.

Table 3
Labor Intensity by Firm Size and Industry-1977

Industry	Small Firms	Large Firms	All Firms
All	14.4* (1.9¢)+	12.3 (1.7¢)	13.4 (1.8¢)
Mining	19.7 (2.6¢)	9.7 (1.3¢)	12.1 (1.5¢)
Manufacturing	23.5 (3.1¢)	15.3 (2.2¢)	17.8 (2.4¢)
Wholesale	6.5 (0.9¢)	3.0 (0.4¢)	4.5 (0.6¢)
Construction	23.4 (3.1¢)	29.1 (3.9¢)	24.5 (3.3¢)
Retail	12.3 (1.5¢)	12.6 (1.7¢)	12.3 (1.5¢)
Service	32.6 (4.5¢)	35.0 (4.7¢)	34.1 (4.7¢)

* payroll as a percentage of sales
\+ OASDI taxes per dollar of sales

Source: SBA

The Payroll Tax and the Programs It Funds

> "There is no case to be made for the present payroll tax as part of the general tax system. From the point of view of income-base proponents, it should be incorporated into the personal income tax. From the point of view of consumption-base proponents, it should be replaced by a personal expenditure tax."9/

This quotation is a clear expression of a conclusion based on a rather widely accepted analysis.10/ Yet, the writer who authored the quote immediately went on to suggest maintenance of the tax,

albeit in a modified form, due to the "context" in which the program (Social Security) exists.

Actually, there are two "contexts" for funding government programs from payroll taxes. The first is the commonly held belief that payroll taxes are used to finance "social insurance" programs. The second is the political context in which groups with vested interests use the payroll tax as a means to leverage their higher priorities. Unfortunately, both contexts are perpetuations of myths which, if ever true, have certainly outlived their utility.

The alleged social insurance programs financed by the payroll tax have never been insurance programs in any meaningful sense of the word. While the Social Security cash benefits program has always contained a crude relationship between taxes paid and benefits received, its essential nature is that of a massive inter- and intra-generational transfer program. On the other hand, Medicare (also a massive inter-generational transfer program) provides benefits which bear little relationship to family income or wage experience. And though Unemployment Insurance might be broadly termed insurance from the perspective of the employee, the lack of adequate experience rating scales often introduces large "socialization" elements which undercut the insurance concept in that program.

The myths of social insurance and payroll taxes have been reinforced by political expediency. The political right usually

adopts the position that payroll taxes are a necessary evil in order to retard the overall growth of social insurance spending and to maintain some semblance of fiscal discipline. Evidence of the dubious logic in that position can be found in the '72, '77, and '83 Social Security amendments, a $200 billion Federal deficit, and Federal extended unemployment benefits. The political left, on the other hand, though often not reticent to employ general revenues in Social Security, tends to believe that at least some payroll taxes ("contributions," as they are euphemistically called) assure political acceptance of programs, payment of benefits as "promised," and payment of benefits without a means test being applied. Of course, the threshholds of income taxation on Social Security and unemployment benefits, the creation of SSI, and the '83 Social Security amendments challenge the efficacy of that position.

Conclusion

It is difficult to find anyone who will or can justify a payroll tax. Yet, the tax has prospered and all indications are it will continue to do so. Aside from future increases already legislated, the National Advisory Council on Social Security is desperately seeking the means to close a projected multi-billion dollar short fall in Medicare, new estimates of life expectancy once again raise questions on the vulnerability of Social Security's cash benefits program, continued high unemployment drains state unemployment funds and the generally precarious condition of state treasuries offers difficult choices for the repayment of borrowed funds, and new

programs such as national health insurance and health insurance payments for unemployed workers are constantly suggested. The traditional method of funding each has been the payroll tax.

Yet, the implications of these trends has to date successfully avoided serious discussion. Center stage is instead occupied by consumption taxes, VAT's, flat-rate income taxes, graduated flat-rate income taxes, etc., all of which are placed in juxtaposition to personal and corporate income taxes. It is as if payroll taxes were givens and we were absolutely powerless to alter them. But payroll taxes are not divinely inspired. Their course can be altered either through reductions in the growth of programs they finance or through substitution of other tax forms. It is time we thought seriously of doing so.

Simplicity vs. Equity

"Logic and taxation are not always the best of friends."

This quote comes from a tax case argued in 1923 in which the judge appeared to have a good grasp on what was evolving from a simple flat rate tax begun in 1913. Recently Congressman Barber Conable, the ranking minority member of the House Ways and Means Committee stated a similar sentiment when discussing tax policy by stating, "equity is the enemy of simplicity."

Small business has always felt frustrated by the tax law because of the inability of Congress to write laws and of Treasury to write regulations which are both equitable and simple. The problems appear to be a misperception of what small business is and what their needs one. One example exists in pension policy in the recently enacted Top-Heavy Plan Rules which were passed in TEFRA (Tax Equity and Fiscal Responsiblity Act of 1982).

During the deliberations over TEFRA, a major concern was raised regarding professional corporations and the fact that the pension plans they were adopting resulted in tax sheltering. Through massive contributions the plans were designed so that only the officers of the corporations benefitted. Small businesses of all categories were lumped into this discriminatory category without the conferees giving any consideration to the fact that most small firms exist for many years without a pension plan. Generally, by the time the business owner is financially capable of supporting a pension plan, he is into middle age, and the plan would be designed to make up for those lost years. This result is not discriminatory to young workers if taken in its correct context.

A positive effect of the pension rule changes in TEFRA are the new higher limits for non-corporate KEOGH plans, which helps maintain some equity between corporate and non-corporate pension plans.

The following is a listing of tax issues which specifically affect small business.

Accounting Methods

Cash Method of Accounting

In many instances, the Internal Revenue Code subtly discriminates against smaller firms because they do not have the knowledge or the resources to hire the experts needed to take full advantage of the benefits the Code offers. Small business owners therefore end up paying a much higher effective tax rate than their larger competitors. An example of discrimination is the IRS-imposed accounting rules and procedures, particularly damaging to small retail, wholesale, and some manufacturing firms that maintain inventories.

The impact of inflation on income and inventories is that businesses pay substantially more taxes than often realized. The Joint Economic Committee has published data that show the effective 1977 corporate tax rates were 66%, not the maximum 48% then prescribed by law. Inflation raises the profits of companies artificially by overstating the value of inventories and understating the value of depreciable assets. These factors combine to slow capital investment and a company's growth rate.

The method of accounting a business uses is reflected in its tax bill. Small business owners do not have the funds to hire costly

tax consultants to help them choose the best accounting method. In fact, they generally employ the accounting method that provides them with the worst cash flow. This in turn restricts their ability to expand by investing in new facilities and equipment. Once again, the small business owner is placed at a disadvantage relative to larger, more established firms.

Because of IRS regulations, the accounting method generally employed by smaller firms is a modified accrual system which accounts for the value of inventories. A solution for the problems caused by accrual would be to allow small firms with inventories to use cash basis accounting.

The cash basis method of accounting is the easiest method for most non-accountants to understand because it conforms to the most basic recordkeeping system. All deposits are income, and all checks written are expenses. However, the Internal Revenue Code mandates "that when the production, purchase or sale of merchandise is an income producing factor, the use of inventories and the accrual method of accounting must be used." The accrual method records income that has not been received, e.g. sale has occurred but no payment for 30 days, and expenses when the liability has been fixed. Recording inventories when using the accrual method increases a small business's tax liability.

Allowing the use of the cash method of accounting would ease a small firm's cash flow problems and simplify its recordkeeping requirements. The cost to the Treasury would be approximately equal to the difference in revenue that would occur if all firms currently eligible would change to the LIFO inventory method. In theory, if small firms had the same capability as large ones for utilizing the most advantageous accounting systems, the revenue loss would be no more than that already accepted under current law.

For small business, being able to use the cash method of accounting instead of the accrual method also would be a valuable simplification.

Capital Formation

In a previous hearing, we testified on capital formation needs for small firms and proposed several tax policy initiatives which would mitigate those capital formation problems. Many of these same proposals result from tax policy situations which discriminate against small firms and their ability to raise capital.

A prime example of this treatment is in the area of direct loans and guarantee losses as they might occur between related and non-related parties. Surveys of small business owners reveal that a primary source of initial capital was funds borrowed from family members.

If the parent of a conglomerate corporation guarantees the loans of a subsidiary, the parent is entitled to a deduction if the guarantee is exercised and it needs to make good on the loan. However, if the owners of a small corporation use personal assets to pay off a business loan under similar circumstances, it is considered a capital contribution to the corporation, which is not an allowable deduction. A similar result occurs when a family member guarantees a business loan, for instead of IRS treating it as a business debt if the guarantee is exercised, it is treated as a gift which imparts no tax benefits.

In general, Treasury regulations treat non-corporate financing situations as non-business debt unless there are unrelated outside investors. While many of these rules are designed to prevent the unwarranted transfer of excessive tax benefits in situations where tax shelters exist, in practice they force small firms into unnecessary tax planning.

As is often the case, the tax law makes insufficient distinctions between tax shelters and closely-held corporations. In fact, a closely-held corporation which consists of 5 or fewer shareholders has been used as an automatic trigger for application of tax shelter abuse rules, such as the at-risk limitation rules. The at-risk rules can limit depreciation and investment tax credit benefits when the owner does not have sufficient personal investment in the business.

Fringe Benefits and Pensions

Fringe benefit rules have long been a point of discriminatory treatment for small firms. The discrimination which occurs is based on differential treatment between corporate entities and non-corporate entities and between publicly-held and closely-held firms. While both incorporated and corporate firms can deduct the cost of health and accident plans, insurance, death benefits and others, unincorporated firms can deduct these same costs but only to the extent they relate to employees.

In addition, if a closely-held corporation or an "S" corporation wishes to have fringe benefit plans, different limit rules can apply depending on whether the person receiving the benefit is designated a key employee.

Pension plans may also provide problems for small business owners who must be concerned over top-heavy discrimination rules and an incredibly complex network of qualifications and benefit rules which prevent most small firms from ever even considering forming pension plans.

Compliance Rules

Small business owners have been virtually singled out as the culprits who are causing the tax compliance gap in America. The invective by some becomes so strong as to make one almost believe that if we could "get" small firms, we might balance the budget.

As representatives of small business, we do not believe that if you impose new stringent reporting and paperwork rules on small firms, too much is gained, for the firms will be those already complying. The underground cash business is not affected by new reporting rules and paying accounting fees required to comply with the new rules, but the taxpaying small business is.

It is important that Congress not view all firms as wealthy, sophisticated, and having computerized information handling capabilities. Too often the opposite is the case. A small firm's information processing machine is often the brain of the owner, and all the firm's assets are tied up in keeping the business going not in luxuries. If this perspective can be applied when compliance problems are discussed, then small firms can get fair and equitable treatment.

Tax Reform and Simplification

Tax reform and tax simplification are being highly touted as major legislative initiatives for the near future, as many in Congress have come to believe that the tax code allows far too many loopholes which are used to avoid paying taxes.

Tax reform can mean restructuring, redistributing income, or increasing tax burdens, while simplification hopefully entails reducing recordkeeping and compliance problems for the average taxpayer. NFIB certainly feels that simplification of the tax code

would be helpful. However, these concerns are overshadowed by the tax burdens from income and payroll taxes to which small firms are subject.

At this time, NFIB is not supportive of any flat tax scheme, corporate integration, value added tax, consumption tax, or national sales tax. For small business, several more fundamental concerns exist in the area of capital formation, discriminatory tax rules on closely-held and non-corporate firms, and payroll tax burdens. Failure to address any of these issues will leave small firms in a situation not much better than where the current situation.

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ENDNOTES

1/ NFIB Fact Book on Small Business (National Federation of Independent Business: San Mateo, CA), February, 1979. For the tax liability of five hypothetical, though typical, small businesses located in 17 different states, see Relative Burden of Federal, State and Local Taxes on Small Business, (ed.) Sharon Virga, Touche Ross and Co., (National Federation of Independent Business: San Mateo, CA), 1982.

2/ NFIB Small Business Problems and Priorities (National Federation of Independent Businesses: San Mateo, CA), April 1983.

3/ Quarterly Economic Report for Small Business, op. cit.

4/ Schiller, Bradley R., ""Corporate Kidnap" of Small Business Employees" The Public Interest, Summer, 1983.

5/ NFIB Credit, Banks and Small Business (National Federation of Independent Business: San Mateo, CA), May, 1983. Also see the Quarterly Economic Report for Small Business, op cit.

6/ There were three principal purposes in graduating the corporate income tax: to provide tax relief for "small companies that are not particularly capital intensive," to reduce the abrupt jump in a two or three rate structure, and to "reduce the impact of tax laws in selection of a form of organization for operation of a small business." See, Senate Committee Report No. 95-1263 accompanying the Revenue Act of 1978, p. 110.

7/ Joel Popkin, The Differential Impact of Payroll Taxes on Small Business vs. Large Business (progress report), mimeo, December 15, 1982.

8/ Social Security: A Tax on Labor (Office of Advocacy, Small Business Administration, Washington, D.C.), January, 1983.

9/ Richard A. Musgrave, "A Reappraisal of Financing Social Security," Social Security Financing (ed.) Felicity Skidmore, (The MIT Press: Cambridge, Mass.), 1981, pp 110-111.

10/ There are some arguments in favor of payroll taxes of which ease of enforcement and collection is probably the most compelling.

Senator GRASSLEY. I presume you are Professor Dunkelberg, is that right?

Dr. DUNKELBERG. Yes, sir.

Senator GRASSLEY. All right. Let me introduce you, because I didn't have that opportunity.

It is my understanding that you are an associate professor of economics at the School of Management, Purdue University.

Dr. DUNKELBERG. That is correct.

Senator GRASSLEY. All right.

We will now turn to you, and then I will have questions of the three of you, so you came at the appropriate time.

I announced prior to your coming that if you like, which I hope you do, we would insert your testimony in the record in toto, and then you can summarize.

Dr. DUNKELBERG. That will be fine. I have already given your aides a copy of the testimony, and I assume that you will have one fairly quickly.

Senator GRASSLEY. Thank you.

STATEMENT OF WILLIAM C. DUNKELBERG, ASSOCIATE PROFESSOR OF ECONOMICS, SCHOOL OF MANAGEMENT, PURDUE UNIVERSITY, WEST LAFAYETTE, IN.

Dr. DUNKELBERG. I suppose, being the last witness, that I don't have to say a whole lot about the importance of small business, either in terms of job creation or in terms of their impact on total employment in the economy.

I should point out that for many years small business was not really thought about when one talked about investment in the economy—plant and equipment investment, and so on—and of course the implications of that investment for productivity. I think that the studies that we have done of small businesses for the last 10 years or so have indicated that that is not really true.

In any given 6-month period, roughly 55 percent of small businesses will make some kind of capital investment. The average is around $15,000, but 10 percent of them will be $50,000 and up. And when you add that up over the millions and millions of firms, you will find that it really has a substantial effect or impact on those numbers that are produced by the Department of Commerce called nonresidential fixed investment in the U.S.

In my testimony I have supplied some analytical results which show you that small businesses plans to invest actually lead and indicate the direction that total investment takes in this economy. So they play a very important role in the physical capital investment that takes place here in this economy.

Other studies have also shown, of course, that small business is disproportionately responsible not only for job creation, but also for innovation—new kinds of ideas that get implemented in the economy both in the physical capital sense—that is, what's a better way to make this machine work, or this process work?—but also from the management and organizational point of view.

Small business is responsible for a disproportionate amount of this kind of innovative and investment activity in the economy.

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In fact, if you bottom line it, I think what you would have to conclude is that small business is in fact the R&D of the U.S. economy. It is in the marketplace that small businesses, the millions of entrepreneurs, get to try out all the new ideas—the new products, the better ways to manage, the better ways to do things, the better ways to organize. If they work, they make money, and the money they make funds their growth and of course attracts people to copy them, which is what competition is all about. And if they fail, those entrepreneurs learn something. And the capital that they have used—the building that they used to be in and the chairs and so on, and whatever else—get used by someone else who is trying a new idea.

There isn't a system that works better for generating progress in terms of innovation, productivity gains, than that system. It is better than the computers that the planners can use, and it's better than any ideas that any economic czar could ever come up with. It is a tremendous system, and it works very well.

Now, what makes that system work so well for us is basically incentive and the profit motive. There are a lot of reasons for starting. When you talk to entrepreneurs, they will say: "Well, I started because I really couldn't work for anybody else," or "I lost my job, and it was a good time to start;" but, bottom line, the main reason for starting is to make money. And those incentives are very important.

The level of taxes, then, that we collect in this economy become a central issue. But, as important or perhaps more important is how we collect those taxes; that is, at what margins do we levy these taxes that we impose? It is important to have incentives to become more productive in this economy, and that's really our major concern.

Productivity, broadly conceived, is really something more than output-per-man-hour. It's getting the most output out of the resources that you have available to you; that's what productivity is all about. And underlying that job, getting that job done, is in fact the incentive to make money. It is to do better than your competitor, to cut costs more so that you can get a bigger chunk of the market, and if all these people are doing the same thing that's the way we get productivity growth.

Now, again I want to point out that this is more than a traditional view of productivity—that is, getting more tractors or trailers per person, but also ideas and management. If we are thinking about productivity, how you organize a production line or for that matter a checkout line, could be as important or more important to productivity in terms of output per man-hour as which machines you use on that line.

So those kinds of inputs are very important, and with the small business sector being relatively labor-intensive they become very important for us. Having our managers and entrepreneurs have the time and the incentive to think about the right way to do these things, to organize activities, is a very important determinant of productivity for this economy and its trend growth.

Now, if we look at actual activity, I suggested that we in fact do a lot of physical investing; that is, we buy a lot of equipment and we produce a lot of plant. But on the human capital side, which is

very important for productivity, I think I should point out that most entrants to the labor force start off with a small business; that is, they get their first exposure to participating in our labor force at a small business. They learn how to become good workers, they learn good worker habits, they accumulate the general capital they need to be good members of the labor force as well as learning a lot of specific skills from the small businesses that they work with.

And of course one exciting part of that is the spinoffs and the incubators and so on that small businesses really set up, which produce a lot of other interesting companies, especially in the high tech areas.

But in general I think we rely very heavily on small businesses to provide improvements in that human capital which gives us the potential for tremendous gains in productivity that we forget about exploiting.

If you look at small business's role in this economy you have got to conclude that the best job creation program you could have is one which stimulated small businesses to grow and to start. That will get us more jobs and get us better training than any other program we can come up with. And I think the facts over the last 20 years have proven that out.

Now, if we look at the impact of the Tax Code, I would like to amplify a little bit on some of the things that John pointed out.

First of all, only about half of the small businesses in the economy are incorporated, which means half of them really pay taxes under the personal Tax Code, and I think we ought to keep that in mind as we look at what is happening in the development of the Tax Code.

These people are not incorporated and don't pay corporate taxes. Let's pay attention to the impact of the personal tax cuts on what is going on there.

The Tax Code sets an important set of prices which allocates resources. And a lot of small businesses tell me in written comment: "Gee, I could double the size of my business in 2 years, but it's not worth the effort." I think we have to consider that when we look at productivity growth and job growth in the economy.

We should also keep in mind that the Tax Code, as John pointed out, allocates credit. The Government is borrowing a lot of money and it's flowing through the Tax Code in terms of cash-flow to businesses. I am not sure we've looked real carefully at whether those are the businesses we want to have that money.

Thank you very much, and I will have my written testimony in the record.

[Dr. Dunkelberg's written prepared testimony follows:]

PRODUCTIVITY AND GROWTH IN THE SMALL BUSINESS COMMUNITY

William C. Dunkelberg

Purdue University

The importance of the "small business community" to the health and vigor of the U.S. economy has become an "in" thing to talk about these days. Our large, traditional industries are in obvious decline, huge new industries are growing out of small entrepreneurial endeavors [the computer and electronics industries for example], and mountains of data are now revealing the role of small business in the job generating process.

The economic credits to this sector of our economy are impressive: Producers of half of the Gross Private Product[1], employers of half of the private non-farm workforce[2], and creators of a disproportionate share of all new jobs produced in the economy[3], these firms are also credited

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[1] Joel Popkin & Co., Gross Product Originating in Small Business: Preliminary Estimates for 1963 and 1972., U.S. Government Printing Office, Washington D.C., 1982

[2] The State of Small Business: A Report to the President, U.S. Government Printing Office, Washington D.C., 1982, pg.52.

[3] David L. Birch, The Job Generation Process, MIT Program on Neighborhood and Regional Change, Cambridge, MA, 1979.

Catherine Armington, "Further Examination of Recent Employment Growth: Analysis of USEEM Data for 1976 to 1980", Business

with a disproportionately large share of the supply of new innovation in the U.S.[4]

In fact, small business is the "R&D" of the U.S. economy.[5] Far superior to the computers of the economic planners, or the dictated directiions of economic czars, the millions of entrepreneurs who test their ideas in the rigor of the marketplace have fostered and supported economic growth in the U.S. unparalleled in history or geography. Any individual with a new idea or product has the opportunity to test its value. Not confined to scientific or engineering discoveries, entrepreneurs test thousands of new managment and organizational ideas in the marketplace, ways to cut costs or do something "better" than existing firms. New products and new concepts are continually introduced and tested. Success brings profits to finance growth and encourage new competition. Failure costs society little - the entrepreneur learns and gains new knowledge while the resources of the failing firm are often re-used by yet another new entrepreneur.

Microdata Project, The Brookings Institution, March, 1983.

[4] N.R. Pierce and Carol Steinbach, "Reindustrialization on a Small Scale--But Will Small Business Survive?", National Journal, Vol. 13, No. 3, January 17, 1981, p.105.

[5] See W. Dunkelberg, "Small Business and the Political Economy", International Congress on Small Business, Malaga, Spain, October, 1982.

The fundamental driving force behind all this activity is the incentive to make money. Although entrepreneurs start firms for many reasons *, the basic motive is to earn the rewards that can come from successful risk-taking. Remove or blunt this incentive, and the rate of entrepreneurial activity will be reduced.

Productivity is also a function of this incentive. In the long run, productivity measures the amount of output obtained from the inputs that are used. The popular measure of productivity - output per man hour, focuses on only one of these inputs, labor. The measure is also impacted strongly by cyclical swings in demand and output, and often reflects firms' reluctance to cut employment as sales and ouptut decline. But, viewed more broadly as finding ways to get more output from a given set of inputs, it can be seen that productivity depends on managerial and organizational skills as well as the amount of real physical capital available. Knowing how to organize an assembly or grocery line can make as large a contribution to productivity improvement as upgrading the machinery on that line.

Productivity is the key to the high standard of living in the U.S. Although many countries have seen productivity improve

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* A. Cooper and W. Dunkelberg, " Entrepreneurial Typoligies", Unpublished manuscript, Purdue University, West Lafayette, IN, 1983.

faster than here in the U.S. in recent decades, in no country of importance is the level of output per capita higher than here in the U.S. But it also appears that associated with the growth of the public sector [measured as a percentage of GNP], we have seen a slowdown in the trend of productivity growth and a decline in the proportion of our domestic product accounted for by small business.

The real key to productivity is competition. Under competitive pressure, firms have the incentive to get the most output it can out of all of its resources, not just labor. The entrepreneur is constantly seeking ways to reduce costs and better his competition. But today, the time of the entrepreneur is diverted from these activities and into hours of paperwork. The incentive to work hard has been diminished by heavy marginal taxes. One small businessman once confided " I could double the size of my business in ten years, but after taxes, it's not worth the effort". The best jobs creating program available is blunted by taxes raised, in part, to pay the unemployed. Small businessmen have continually cited as there most important problems concerns that arise from Washington D.C., and not their competitive environment. Washington is the biggest source of uncertainty for the business community. The list of major concerns for small business includes inflation, interest rates, government bureaucracy and red tape, and taxes as the top items.[7] How taxes are raised is an important an issue as the

level of total taxes. In general, we have tended to provide disincentives through the tax code to the very individuals and institutions that could contribute the most to job and productivity growth in the U.S.

Historically, small business has been treated as if its performance was of little consequence to the economy. Policy debates and, in particular, tax code issues were oriented around the large and conspicuous industries in the U.S. But, as can be seen in Table 1 and Chart 1, small business makes a substantial contribution to the level of investment activity in the economy. Between 50% and 70% of all smal firms make some kind of investment in plant and equipment in any given year. The typical expenditure is about $15,000, but many outlays amount to several hundred thousand dollars. When summed over the millions of small firms making these outlays, the aggregate National Income and Product Account figures are substantially impacted. It is clear from Chart 1 that small business investment plans are good predictors of the strength and direction of plant and equipment investments for the entire economy.*

Another important contribution to productivity growth in the

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* Quarterly Economic Report for Small Business, National Federation of Independent Business, San Mateo, California.

* Quarterly Economic Report for Small Business, National Federation of Independent Business, San Mateo, California.

investment in human capital made through employment in the small business sector. A very large proportion of all entrants to the labor force receive their initial "on the job" training by working for a small firm. As can be seen in Chart 2 , small firm decisions to expand and contract employment is a major determinant of employment growth in the U.S.* Yet labor taxes are continually increased, discouraging the hiring of many employees, especially the young and the less skilled, denying these individuals the training and exposure to the workplace environment so necessary to the development of good working habits and specialized skills.

Economic units respond to incentives. Small Businesses are no exception to this most basic of economic rules. The tax code determines a very important subset of the "prices" that direct the flows of economic resources in our economy. When the government is running such substantial deficits, the tax code also acts as a credit allocation device, providing additional cash flows to some firms while the government does the borrowing to finance those capital flows. It is not at all clear that the capital allocation achieved through the tax code is the one that makes the most substantial contribution to our growth in capacity and productivity, and I certainly support your concern over this issue.

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* Quarterly Economic Report for Small Business, National Federation of Independent Business, San Mateo, California.

Table 1

TYPE OF EXPENDITURE

Year	Equip & Veh	New Bldgs	Imp Bldgs	Add Land	% Making a Least One Type of Expenditure
1981:2	44%	7%	16%	4%	53%
3	43	7	17	5	53
4	42	7	19	4	53
1982:1	43	8	17	4	53
2	41	7	16	4	52
3	37	6	16	4	47
4	38	7	15	3	48
1983:1	40	6	15	3	50
2	40	6	14	4	49
3	42	7	15	4	53
4	43	8	17	5	55
1984:1	46	7	16	4	55
2	42	6	14	4	56

TABLE 2

TOTAL CAPITAL OUTLAYS

Year/Qt.	Under $5000	$5000-$19999	$20000-$49999	$50000-$99999	$100000 or More	None
1981:2	14%	19%	9%	4%	7%	47%
:3	14	19	9	5	6	47
:4	16	18	8	5	6	47
1982:1	15	18	9	5	5	47
:2	14	20	8	5	5	48
:3	15	17	6	4	5	53
:4	14	18	6	4	6	52
1983:1	16	18	7	4	5	50
:2	13	19	8	4	5	51
:3	15	20	8	4	5	47
:4	16	21	8	4	6	45
1984:1	15	20	9	5	6	45
:2	14	22	10	5	5	44

CHART 1

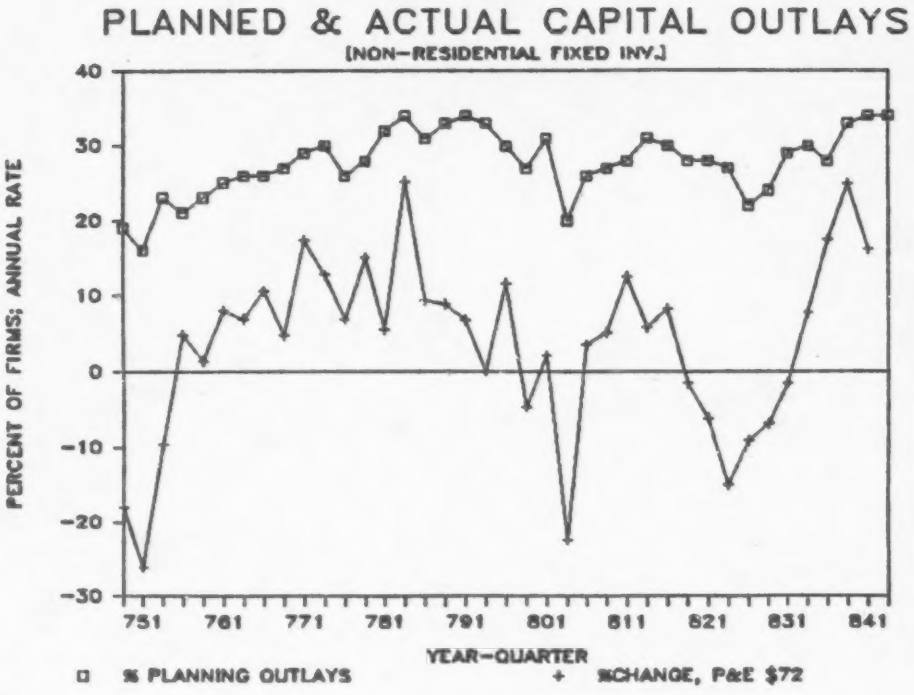
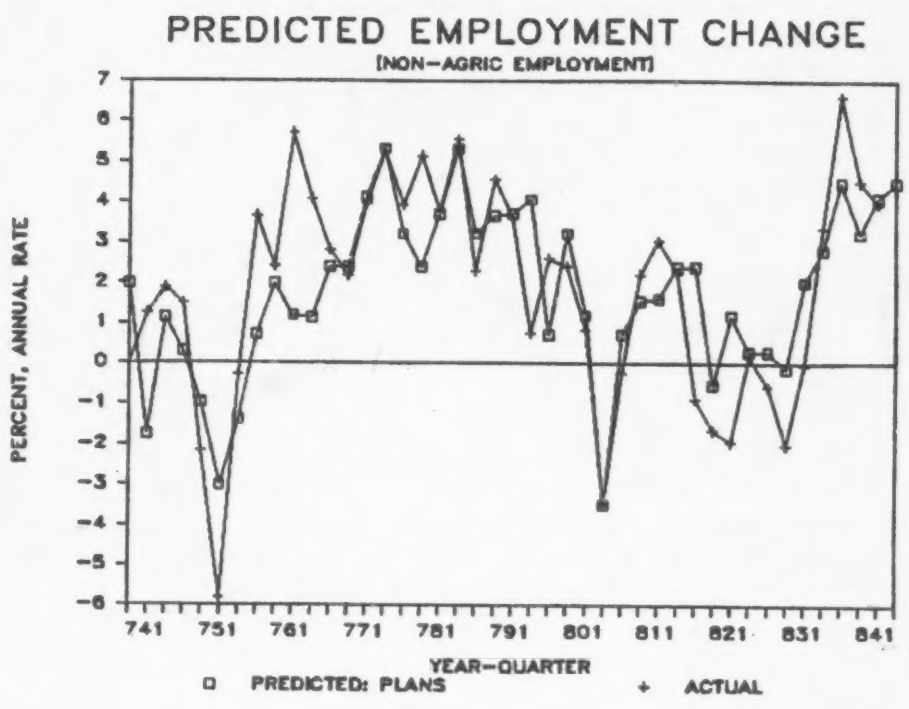
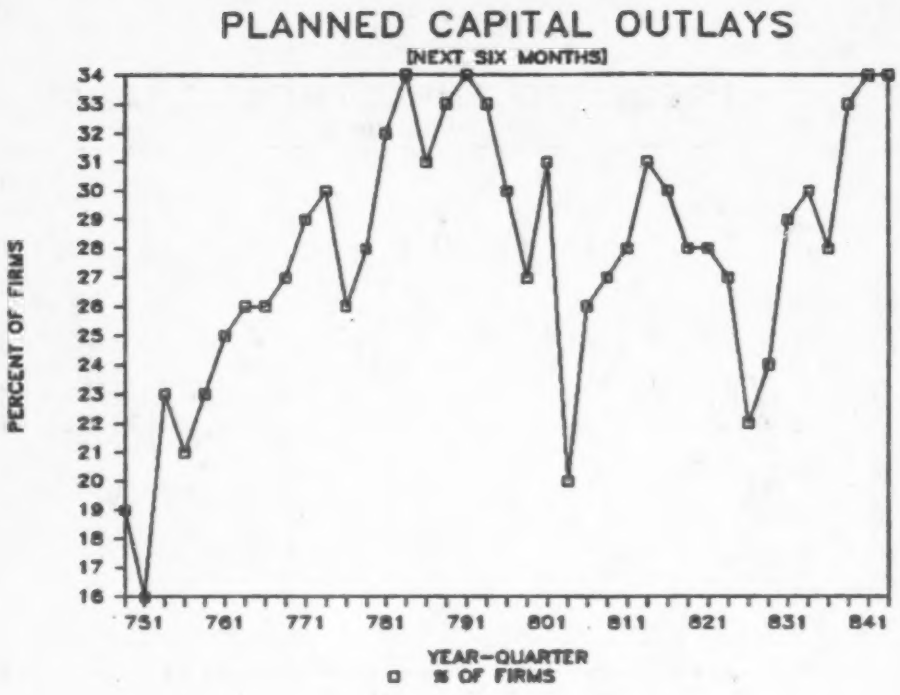

PLANNED & ACTUAL CAPITAL OUTLAYS
(NON-RESIDENTIAL FIXED INV.)
PERCENT OF FIRMS; ANNUAL RATE
40
30
20
10
0
-10
-20
-30
751
761
771
781
791
801
811
821
831
841
YEAR-QUARTER
□ % PLANNING OUTLAYS
+ %CHANGE, P&E $72

CHART 2


PREDICTED EMPLOYMENT CHANGE
(NON-AGRIC EMPLOYMENT)
PERCENT, ANNUAL RATE
7
6
5
4
3
2
1
0
-1
-2
-3
-4
-5
-6
741
751
761
771
781
791
801
811
821
831
841
YEAR-QUARTER
PREDICTED: PLANS
ACTUAL


PLANNED CAPITAL OUTLAYS
[NEXT SIX MONTHS]
PERCENT OF FIRMS
34
33
32
31
30
29
28
27
26
25
24
23
22
21
20
19
18
17
16
751
761
771
781
791
801
811
821
831
841
YEAR-QUARTER
% OF FIRMS

PREDICTED UNEMPLOYMENT RATE
(BASED ON SKILLED JOB OPENINGS)
UNEMPLOYMENT RATE
11
10
9
8
7
6
5
4
741
751
761
771
781
791
801
811
821
831
841
YEAR-QUARTER
ACTUAL
PREDICTED: OPENINGS

Senator GRASSLEY. I want to thank each of you very much. I suppose I would like to start off and ask Bruce to clarify a question I had in my mind as I heard his testimony and then heard what Mr. Motley said.

Is there conflict between the two of you as you presented in your oral testimony?

Mr. BARTLETT. No, I don't think so. I think that it is more the perspective of an economist as opposed to one who is representing an organization made up of established small businesses.

I guess that I would say that my main concern is the small businesses that don't exist yet, that we want to encourage to become small businesses, and not measures which may simply aid existing small businesses but don't necessarily do much to help entrepreneurship.

Senator GRASSLEY. But you find no disagreement with the fact that Congress has put some emphasis upon tax legislation targeted toward small business?

Mr. BARTLETT. Well, my concern is that some of these incentives in the past have been inframarginal; that is, they reduce your tax liability without encouraging you to necessarily do anything productive. And what I want to do is encourage productive activity, not just give out unnecessary subsidies through the Tax Code.

Senator GRASSLEY. All right.

I am not directing my question toward a specific person from this point on, but I would like any or all of you to respond as you might feel moved and as you have an expertise to so do.

Do you think that our present system of taxation has a bias against inventory accumulation, which many people feel is the lifeblood of all business?

Mr. MOTLEY. Senator, I guess maybe I should respond to that.

We definitely feel that the present tax system has a bias against inventory accumulation in many ways. As I mentioned in my testimony, that part of the code from our perspective is as archaic as depreciation accounting was in the past. During periods of high inflation, which of course we are not in now but were in the cycle previous to this, small firms were really having a very difficult time being taxed on the paper profits which were coming out of their inventories.

We definitely would like to see a complete review of the entire inventory tax area.

And we would also like to see, if I can mention it, a different attitude on the part of the Treasury Department, which views this whole topic as being one of nothing more than small businesses wishing to find tax shelters for their money. And that is not necessarily the case. As you said, it is the driving force in many, many small businesses, and it means a great many jobs across this country and in the economy.

Senator GRASSLEY. I should have asked in conjunction with the question—and pardon me for interrupting you, and then you can continue—do you favor direct expensing, whether it be for inventories or whether it be for raw materials used in manufacturing?

Mr. MOTLEY. We definitely favor direct expensing, yes.

Senator GRASSLEY. I interrupted you; do you want to continue?

Mr. MOTLEY. The only comment I was going to make on your previous question is, one of the difficult things that you as legislators have to do in viewing the small business community is to realize that it is not monolithic or homogeneous, that it is really terribly diverse out there and some of the things you do will affect one part of the community differently than others.

Back in the late 1970's we reduced corporate taxes substantially for small corporate taxpayers; in the early 1980's we addressed depreciation reform for capital-intensive small business taxpayers. We have other groups that we have to address.

We also reduced personal income taxes substantially for those firms which operate as noncorporations; but we have not addressed the inventory area at all yet. We really haven't addressed the capital formation area in small business at all yet. Those are two big jobs that I think the Congress needs to take a look at in the 1980's.

Mr. BARTLETT. Mr. Chairman, if I could just mention something, one of the biggest problems with an inventory is the effect of inflation. The Tax Code already allows the use of LIFO inventory valuation, and my understanding is that the vast majority of corporations and businesses simply don't use it. Why, I don't know. Maybe there is some IRS regulation or something that makes it difficult for them to do this. But simply switching from FIFO to LIFO would take care of a great deal of the problem that results from inflation, at any rate.

Mr. MOTLEY. Small businesses do not use LIFO. You are 100-percent accurate in saying that this would take care of it. They don't use it because it is too complicated. They do not have the accounting expertise; they do not have the computers or the software to allow them to go into it.

Again, I would point out the statistic that I mentioned from our survey in the 1970's: A full 25 percent of our membership does not have any outside assistance as far as their accounting procedures or their taxes are concerned. So even those things that are in the code which require the slightest degree of sophistication are not used. They never used acceleration depreciation; they used straight line. Why? Because it was simple, and they could understand it. And you are faced with the same situation in inventory accounting.

Senator GRASSLEY. Well, Mr. Bartlett, were you saying in comment on Mr. Motley's statement that there isn't a problem in that area?

Mr. BARTLETT. Well, potentially there isn't a problem in the sense that, as I said, the distortion here is caused by inflation, which causes you to in effect pay capital gains taxes on your inventories, which you shouldn't have to do. If you valued your inventories on the last-in, first-out basis rather than a first-in, first-out basis you would eliminate that problem.

So in terms of the Tax Code, the problem is dealt with. Maybe the problem is in the regulatory area or perhaps it is somewhere else. I don't know why a small business would find these things too complex to do, but I will just have to take Mr. Motley's word that they do. I don't know what else to add to that, really.

Senator GRASSLEY. In regard to how complicated that is, with the coming of the computer and their ability to take care of some of

this, the complicated aspects of it, we could use cost-averaging or something instead of LIFO, as an example. Right?

Mr. MOTLEY. It certainly is going to help address the problem.

But I would ask you, you know, in your travels throughout Iowa, as you walk through every main street in those towns out there, just which firms are going out and purchasing computers. You do have a level of sophistication.

Senator GRASSLEY. Probably one-half of 1 percent, and maybe less than that at this point. I am talking about we are looking to the future in this hearing as well, you know. So I am suggesting that.

Mr. MOTLEY. Less than 2 percent of all corporations in the United States use LIFO. And I think if you take a look at those, they are the Fortune 1000 and not too much below that. It is a very sophisticated method of accounting.

Senator GRASSLEY. Professor Dunkelberg.

Dr. DUNKELBERG. I would have to concur with that. And also, I agree that we are talking about the long run, but in terms of how we are dealing with the Tax Code, the long run isn't that long. It is going to take a fair amount of time for the new computer technology and the kinds of software that these fellows need to be able to use to really substantially infiltrate the ranks of these small firms. And for many of them it really won't happen for a long time.

It is easy to forget how small they are, but the average size in terms of the number of employees is around five or six, and the median is even smaller than that. We are talking about fairly small firms, and even today investing in a computer system with minimal requirements would be many thousands of dollars off the bottom line. And with whatever tax benefits there are, it is still a fair chunk of money, and I don't think the payoff is going to be there at least in the next 5 years for these people.

Mr. MOTLEY. And if the 90-percent business-use test that is in the Senate version of the tax bill gets through, there will be even fewer of them investing in small computers.

Senator GRASSLEY. Well, because of the Mercedes dealers lobbying, it's not apt to get through. [Laughter.]

Mr. MOTLEY. That's good news.

Dr. DUNKELBERG. I would like to make one quick comment about Bruce's observation about tax cuts that are allegedly received for doing nothing.

I think many people feel that if you give business—"big, bad business"—a tax cut, they just pocket the money and run. However, I submit to you that in the long run, evidence would not suggest that that is the case. In particular small businesses is a very competitive area. If it becomes more profitable to be a small business because we have changed the Tax Code, I suggest that in the longer haul, and I don't mean even more than 5 years, you will find a lot more entry. People will come in, you will get more competitors, and sure enough you will not be making these excess returns just because we changed the Tax Code. On the other hand, it does provide the company with more money, and a good competitor will use at least some of that money to improve the business, expand it, whatever. I don't think that we have to be that concerned about tying any particular tax benefits to going out and

overtly doing something, because that then says that we know what it is you ought to be doing or at least we can define a range of things you should be doing. I don't think we are that good. I think we should leave that up to the marketplace.

Senator GRASSLEY. On depreciation, should it be geared to obsolescence as opposed to a specific time period? And would that or would it not have an impact upon productivity?

Dr. DUNKELBERG. That's another very thorny question. I see nobody is jumping to the fore to deal with that.

As economists we would like to have it tied to the true economic life of the equipment or the building. But of course that is a very difficult thing to estimate because today it may have a 10-year life, and with a new invention or change tomorrow it may have a zero life.

From a simplification point of view, gee whiz, those things can get very difficult for small businesses to handle; consequently, you tend to find small businesses sticking with very simple approaches to those kinds of issues even when there are options available that might in fact, at least front-end, give you a lower tax liability and therefore more on the bottom line. You know, we tend to stick with fairly simplistic approaches to the depreciation problem.

Senator GRASSLEY. Well, is it as difficult for business or for the Congress, who would try to write tax policy based upon that?

Dr. DUNKELBERG. Well, both. The harder Congress tries to write a complicated set of regulations and policies that try to approach what we might feel to be an ideal, the tougher it is going to be for some firm to implement it, to understand where you fall into this hypothetical spectrum of economic lives, for example. So the more Congress tries, I think, to proscribe the kinds of behavior we would like to see with regards to depreciation, then the more complicated it is going to become for small businesses and business in general to comply with that.

Senator GRASSLEY. Well, are you saying maybe that would tend toward negating productivity? Or that it wouldn't have positive impacts on productivity?

Dr. DUNKELBERG. Well, it may or may not. I am not sure how it is going to affect productivity unless we are thinking in terms of are we going to supply relatively more or less money by doing this to the firm in terms of cash-flow, depreciation savings, and then that money will be invested.

Now, if the objective is simply to provide more bottom-line money to be invested, like we have essentially done over the last few years, then there have got to be easier ways to do that than to try to devise a very complicated set of procedures for depreciation.

Senator GRASSLEY. Well, as ACRS is a trend in that direction, still keeping time periods, but shorter in most instances, the argument was that you encourage investment, particularly as capital might replace labor, we are going to be more productive and be better off and more competitive as a result now. I hope that's anticipated.

The anticipated results are coming about now, and I assume that if you geared it more toward obsolescence we would argue the same thing. My question is whether or not we are headed in that direction and if we will more fully accomplish our goals.

Dr. DUNKELBERG. If we geared it more toward true obsolescence, assuming we could figure out what that was, then you may be right. Economists may argue that that leads to a better allocation of capital; that is, the right people get the benefits from the depreciation so that they go out and then make the investment.

I submit, however, that it is going to be a very complicated process to try to define in a tax code and that we will end up making as many mistakes as correct decisions, and on balance we may not get a whole lot of progress out of further complicating the depreciation laws.

I am sure John has a comment on that, and I'm sure Bruce does, too.

Mr. BARTLETT. Well, I was just going to mention a couple of points. One is that I think the only reason we are worried about depreciation is because of the Tax Code. I think if we didn't have to worry about the extent to which people's tax liabilities depend on which depreciation schedule they use, they would use whichever one suited their accounting principles. Ideally, you would want to depreciate based on real economic depreciation and not some arbitrary standard.

But short of that, I don't really see that there is much you can do except go to straight expensing of everything. But at the same time you would have to be concerned about how this might interract with such things as the investment tax credit to create windfall kinds of gains for certain firms.

I would also mention that one of the problems with depreciation is the bias that it creates against small firms, which I mentioned earlier, in the sense that a new firm starting up generally doesn't have any profits and therefore no tax liability, and so all of the depreciation in the world is not going to do them any good.

What you need, really, is something like the leasing provision that allows them to get real cash money up front for these tax liabilities that they have.

Another point which I would like to mention is that we have an increasing problem with our economy as we move more and more toward human capital. A lot of the capital is in people's heads, in terms of what they know about how to use new technology and things like that. How do you depreciate that? I think you can depreciate baseball players and things like that, but I don't know how you depreciate engineers in Silicon Valley.

Dr. DUNKELBERG. And that does hurt small business, because, relative to the whole economy or to the large firms, small businesses are very labor-intensive firms.

Just to restate a point I think Bruce is making and that I made earlier in my testimony, although perhaps a little too esoterically, the Tax Code is actually allocating credit.

Businesses now have—who knows how much? I haven't seen any recent estimates—$50 billion more in cash-flow than they would have had without these changes on the depreciation side. But in the meantime, the Government is borrowing that extra $50 billion, more or less; so what we have is the Government borrowing money, allocating the funds to firms through the Tax Code. And the way those get allocated, with a heavy bias toward physical capital, really leaves small business on the short end of the stick.

Senator GRASSLEY. Congress used to pass major changes in the Tax Code maybe once every decade, more recently maybe once in 4 years, and now in the last 10 years we have probably been passing one every year and a half or so, on the average. Has that had a negative impact on small business?

Dr. DUNKELBERG. I would say absolutely so. We are talking about long-term planning, which means trying to figure out whether an investment makes economic sense over at least the economic life of the asset, which is many, many years, and that becomes very difficult to do with the Tax Code changing, especially retroactively.

More generally, we ask small businesses all the time: What are the major problems that you face? They list them off, and we have 10 or 12 major problems that we look at. What you find in looking at that list are taxes, inflation, problems with interest rates, government regulation, redtape, essentially all of the uncertainty coming out of Washington. So we spend a lot of time worrying about what is going on in Washington rather than minding our own businesses, and that ties to a point that John Motley made, which is that one of the harsh taxes imposed out of Washington is the tax on the entrepreneur's time—the paperwork and the time taken to anticipate what is going on.

Since management time is so important to productivity, especially in a labor-intensive sector like small business, we need to get more of the entrepreneur's time focused on business and not the changes that are happening here, or the prospective changes, and all of the uncertainty that that produces.

Mr. MOTLEY. I am going to agree 100 percent as far as the problems created by this continuous flow of tax legislation, and I will just give you one example:

Fringe benefits, the pension plan area. What Congress has done in the past 6 or 7 years has been just basically forced every small business with a pension plan to go out and visit its accountants and lawyers every year to have them review that plan, and pay, you know, $500,000 fees every single year to make sure they are in compliance. Why bother to have one? It is not mandatory. Why should you go through that every single year? It has really created a tremendous problem. It is the pension actuaries re-employment act just about every other year that comes out of Congress.

So I am going to agree 100 percent with Dr. Dunkelberg on that one.

Mr. BARTLETT. One point I might mention is the problem that businesses in general don't know when a particular incentive is enacted into the code whether it is just going to be taken away from them a year or two later. I think the example of tax leasing is one that the people remember and will remember in the future, where something was done with all of the best of intentions and all of a sudden the press started making ridiculous charges. The next thing you know, the Congress took it away.

One of the things I pick up from talking to my clients, for example, is their feeling that if the Congress is willing to pass a major tax increase in an election year, who knows what they are going to do next year? They are already looking ahead to next year's ta bill, which nobody is even thinking about or talking about, with the eye that if the Congressmen and Senators are worried about

getting reflected and are passing tax increases anyway, they are going to do far worse when they are not worried about getting reelected in a nonelection year.

Mr. MOTLEY. Senator, we are going to be having a conference here during the second week of June of 100 small business people from around the country nominated by the four major small business organizations, and already one of the suggestions that has bubbled out of that group is to ask Congress not to pass a tax bill except once every 4 years. It is a very serious problem.

Senator GRASSLEY. I don't disagree with your comments, and I appreciated your organization helping us deal with a subject on the expenditure side during the last budget debate that we just had.

One other question that I asked Secretary Merrifield that I wanted to ask each of you: If we were to go to an alternate tax system, whether that be a value-added, national sales tax or a gross income tax, and some of those could be a supplement to the existing tax but I don't think of it that way and hope that it doesn't happen—I see it as a replacement—would the transition have any negative impact on the productivity of small business?

Mr. BARTLETT. It might. Transition has always been a major obstacle to reform, because every time you enact some special provision of the Tax Code it becomes capitalized. People don't want to suffer windfall losses, and you don't want to give out windfall gains because some people happen to have gotten into a particular business or have organized their finances in one way as opposed to another.

One suggestion I have heard people mention which might be worth considering, and this is not original with me, is the idea of setting up a parallel tax system—keep the existing system in effect for say 10 years or even 20 years and have another system which would be, let us say, based on a flat-rate system or something like that, and you give people the option of being in one or the other. But once they had opted into the new system, they couldn't go back. And of course any new people coming into the economy would have to use the new system.

As the years went by, you would gradually eliminate the capitalized aspect of the old system, and you could then eliminate it at far less cost, for there would be far fewer people to object to its ultimate elimination down the line.

I haven't thought it through any further than that, but it is something that we might be considering.

Mr. MOTLEY. Senator, I would certainly agree with you that the tax should replace any of those that are out there now, and I would suggest very strongly to you that the first one you should take a look at is the payroll tax, from a small business standpoint. Anything that is done to increase revenue in the other avenues should, in our estimation, be looked as a buy-down on payroll taxes or a complete elimination on payroll taxes.

The second part of your question, on whether there would be an impact on productivity during the transition, I would think it would depend on which way you would go. We have stated many, many times up here, all of us, that small business is labor-intensive and its productivity depends to a great deal upon its people, and if you moved any sort of a consumption tax or any sort of a VAT, you

are talking about impacting probably the productivity of smaller firms because they are the ones that are going to collect it. Small business owners don't particularly care for that and have opposed those types of taxes in the polling that we have done.

So I think, really, each type of tax which is on the table is going to have its own type of impact. I think Congress is going to have to take a very careful look at them to see what the impact is in the small business sector.

Dr. DUNKELBERG. Keeping in mind I think Bruce's comments about the fact that when we make changes in the Tax Code we are really helping somebody and hurting somebody else, a redistribution occurs, the other thing to keep in mind is that whenever we change things, that imposes costs. So in that sense, a transition to a new tax scheme could be counterproductive or could cost us in terms of productivity if in fact switching to it used up a lot more resources than say the benefits we gained through new incentives or the removal of disincentives, or whatever that turned out to be.

On the other hand, if the new tax program turned out to be one that was much easier to use, then I suppose that one could argue that we could easily come out ahead on the deal, both by saving resources in terms of compliance and keeping up with it, and all the IRS paperwork and so on, plus having a good knowledge of what your business is going to be all about in terms of the Tax Code. Those benefits could overwhelm any of the transition processes. I guess it would be very difficult to answer that question if we had a tax bill, but it is even more difficult to answer without a specific proposal to look at.

But if we go in the direction of some kind of simplification and keep in mind that these taxes that we impose are really prices or disincentives—they move resources then we may gain. You know, we get firms doing things that don't make any sense simply because of the Tax Code. If we were able to deal with some of those kinds of dislocations, then in fact, the cost of shifting may well be overwhelmed by the benefits, if we have a properly designed system.

Senator GRASSLEY. I am finished with my questioning except for one final comment, taking off where Bruce left off.

You suggested maybe a dual track. Is that based on thought in the abstract, or is there some historical precedent someplace in Western civilization for such a transition from one to another?

Mr. BARTLETT. I have never heard of such an idea, and this idea wasn't original with me. I think I once heard it attributed to Senator Long as the one who thought this idea up. Every time I have mentioned this to tax professionals they always think of a thousand reasons why people would be able to shift their assets from one system to another—things like this—so I have no doubt there are problems with it.

But I think we have to think more about the transition to some sort of new system at the same time we are thinking about what that system would look like, because the political barriers to it are just going to be enormous if it is truly radical and truly different and not just tinkering and incremental. But I think the benefits would clearly outweigh the costs.

Senator GRASSLEY. Most of our transitions before in both State and Federal taxation in the 200-year history of this country has all been incremental.

Mr. BARTLETT. It has also been mostly upward.

Senator GRASSLEY. Yes.

Mr. MOTLEY. More complications.

Senator, just one comment on that. It is an idea which should be closely looked at, but generally when you have a transition period, when you have it dual track or just incremental, it does create problems in simplicity or complexity which again would have an impact upon the bottom half of the small business community much more so than those people in the top half who can afford to go out and pay the prices needed to get the expertise to help them get through the transition.

So I would simply call that to your attention. Remember that you are dealing with—at least the bottom quarter—a fairly unsophisticated group of entrepreneurs as far as the Tax Code is concerned.

Senator GRASSLEY. In closing I want to suggest to you, as I did to the Assistant Secretary, that this is going to be an ongoing discussion, and we would encourage you to keep in touch with us as much as you can with any updated information as we try to see how we can make the Tax Code encourage productivity.

Thank you very much.

Mr. BARTLETT. Thank you, Mr. Chairman.

Mr. MOTLEY. Thank you.

Dr. DUNKELBERG. Thank you.

Senator GRASSLEY. Our last panel is one that deals mainly with agriculture. We have James Miller, assistant legislative director for the National Grange; Grace Ellen Rice, assistant director, national affairs division of the American Farm Bureau Federation; and David Senter, director, Washington office of the American Agricultural Movement.

I would ask you to be seated and proceed on the same basis that the last panel did, with Mr. Miller going first, Ms. Rice second, and Mr. Senter third.

STATEMENT OF JAMES MILLER, ASSISTANT LEGISLATIVE DIRECTOR, NATIONAL GRANGE, WASHINGTON, DC

Mr. MILLER. Thank you, Senator.

I am Jim Miller, assistant legislative director of the National Grange. I appreciate very much the opportunity to be here today and particularly the challenging nature of this hearing. I think it is extremely important and I think, sitting in the audience today, very productive for me anyway to look at the tax system and particularly its impact on productivity in agriculture.

Clearly, agriculture is a model for productivity in the adoption of technology and putting that technology to work feeding people, clothing people, and generally making this Nation and the world, indeed, a bit healthier for the task.

But I think it is equally important to look beyond where we have been over the last few years and what we have accomplished to

where we are going and to what may be accomplished in the future.

The National Grange is of the opinion that the tax system is having quite an enormous impact on agriculture, and we are beginning to see some trends that we find alarming in certain commodities, in certain productive segments of the agricultural economy. And it is our opinion that a lot of these changes are being driven by the Tax Code and not being driven by any intense desire to get into agriculture for any other purpose other than using its tax preferences.

I was quite taken with the remark by your first witness Secretary Merrifield's indication that targeted industries are industries doomed for trouble.

I think three economists—Davenport, Boehlje and Martin—in their USDA report, "The Effects of Tax Policy on American Agriculture," do a very good job in summing that up. And if I may quote for just a minute, they say:

> If a sector of the economy presents a tax shelter opportunity, it will likely have lower product prices, become owned by high-bracket taxpayers, likely have a greater separation of management from ownership, perhaps become less sensitive to market forces, and be dependent upon highly-sophisticated financial advisors, and be subject to the acquiescence of lenders.

They go on to indicate:

> Were agriculture less tax favored than it is, land prices would undoubtedly be lower, there would be less need for sophisticated financial and tax advice, the holding period for farm assets would likely be less, there would likely be a higher proportion of owner/operators in farming, there would be fewer high-bracket taxpayers in farming, and farmers might be younger on the average.

I think that much that has been written involving the tax aspects of agriculture would lead one to the impression that it is a very, very lucrative tax shelter. It is in fact that; there is no question about it.

And those tax shelters do not affect all segments of the economy equally, of the agricultural economy equally. The President's Economic Report to Congress stated that very clearly:

> Several features of the income tax law, some of them unique to farming, may encourage greater investment in productive capacity and expanded production

That's true.

They go on to say that modern agriculture's relative capital intensive reliance on purchased immediate inputs and export earnings integrate it tightly into the rest of the U.S. economy. That, too, goes without saying, but I think the report's most striking conclusion to us is that there is more income lost through tax shelters in agriculture than there is income drawn into the Treasury by taxes on farm profits. And that figure is to the tune of for every $1 taxed on farm profits, $2 of income—and I might add, parenthetically, from any source—are sheltered through agricultural investments.

Now, our point is clearly this: I am not that much of a tax expert, I think there are people here much more competent than I to go into this at length, and I hope that this committee will be getting some additional testimony in this manner, but I think it would be very fruitful if in light of the 1985 farm bill coming up, and it is going to be a protracted process to say the least, it might

be fruitful for this committee and the Senate Agriculture Committee to sit down in a joint hearing and explore this very issue and try to look at that in terms of what we might be doing in terms of farm policy aspects that would get around the problem, or get to the problem anyway, of over-investment in agriculture, and we feel that that is the result, and at the same time look at our farm programs and try to determine how better they could be structured in that light.

I think, clearly, the Grange contends that if and when agriculture becomes so heavily addicted to nonfarm capital just in order to keep the industry afloat, that productivity will in fact decline. I think that decline will be even more dramatic if the capital inflow is shelter oriented, because I do think that it does distort the supply-demand dynamic at work, and it also distorts the profit-motive dynamic as well.

Thank you.

Senator GRASSLEY. Grace Ellen.

[Mr. Miller's written prepared testimony follows:]

STATEMENT OF THE NATIONAL GRANGE

by

James C. Miller, Assistant Legislative Director

before

The Subcommittee on Oversight of the Internal Revenue Service
U.S. Senate Committee on Finance

May 21, 1984

Chairman Grassley and Members of the Subcommittee:

On behalf of the National Grange and the nearly 400,000 Grange members nationwide, let me express our appreciation to you, Mr. Chairman, for calling this hearing to explore the impacts of the tax system on productivity in agriculture. The topic is not only a timely one, but it is one that requires the attention of Congress and the industry itself.

Without a doubt, the tax system has had an enormous impact on the productivity of agriculture. Agriculture is often held as a model for other segments of the economy because of the enormous gains in productivity over the past century. I would like to take the Committee's time to examine this productivity in light of its consequences other than how many people the U.S. farmer feeds compared to fifty years ago. But that statistic is a staggering one. Agriculture's strides in productivity have paid enormous dividends to this country's health and security, and in addition we have taken on the task of helping to feed a hungry world. Tax policies have aided in this effort, but it is proper to look beyond the rosy picture it paints to its impacts on the fundamental structure of agriculture. More appropos to today's discussion would be the question: What will the structural trends in agriculture have on productivity?

The President's 1984 Economic Report to Congress began to explore this question by stating that, "Several features of the income tax law, some of them unique to farming, may encourage greater investment in productive

capacity and expanded production." The report goes on to list such items as cash accounting, depreciation schedules for capital assets, investment tax credits on capital items, and finally, lower capital gains tax treatment. The Report fails to list the advantages of agricultural investments for estate and gift tax planning which is growing in use.

Quoted at length below is the Report's analysis of the effect of tax policy on agriculture.

> "Tax policy does not affect the profitibility of all types of farms equally. The tax laws encourage the substitution of capital for labor. Larger farms, which generate higher incomes, appear to gain proportionately greater benefits than smaller farms. People in higher marginal tax brackets can benefit more from the tax provisions. This creates an incentive for higher-income people to invest in farming. In practice, losses from farm operations reduce taxes on other income by more than the total federal tax revenue from farm profits, implying that total farm income for tax purposes is negative."

The last sentence of the paragraph is deserving of further attention. The true statistic should have been mentioned. "Losses from farm operations reduce taxes on other income" by twice the amount of "the total federal tax revenue from farm profits..." Stated otherwise, income tax shelters from farm lossses is twice that collected from farm profits. Once again, for every dollar collected in farm profits, two other dollars of income are sheltered.

This bountiful oasis for investment dollars will obviously bear heavily on statistics regarding farm productivity. The result will show high volume of production resulting from the high volume of investment. The President's Economic Report states, "Modern American agriculture's relative capital intensity, reliance on purchased intermediate inputs, and export earnings integrate it tightly into the rest of the U.S. economy." It does indeed -- both ways. It is integrated from the standpoint that agriculture is a high user of investment capital, and it is integrated, too, in terms of its vulnerability to immediate responses to economic pressures.

Agriculture's magnetic effect on investment capital implies that other investments will be foregone. The tax code's preferential treatment of agricultural investments leads to reduced availability of capital for other ventures, deposits, purchases, and of course, income taxes. Davenport, Boehlje, and Martin state in their USDA report, "The Effects of Tax Policy on American Agriculture":

> "In summary, if a sector of the economy presents a tax shelter opportunity, it will likely have lower product prices; become owned by high-bracket taxpayers; likely have a greater separation of management from ownership; perhaps become less sensitive to market forces; be dependent upon highly sophisticated financial advisors; and be subject to the acquiescence of lenders."

With this analysis in mind, the authors conclude:

> "Were agriculture less tax favored than it is, land prices would undoubtedly be lower, there would be less need for sophisticated financial and tax advice; holding period for farm assets would likely be less; there would likely be a higher proportion of owner-operators in farming; there would be fewer high-bracket taxpayers in farming; and farmers might be younger on the average."

It is difficult to arrive at any conclusion but that tax policies are having an effect on agriculture other than those anticipated, and in many instances, desired. No federal policy on agriculture would advocate high land prices, reliance on sophisticated financial and tax advice, separation of land ownership from producers, or one that would reserve farming for high-bracket taxpayers. But the overall question is one of productive assets and how they are utilized in a competitive economy. We have a tax system that is encouraging nonfarm investment in agriculture while Congress continues to wrestle with the problem of surpluses and low commodity prices. Congress will not, nor should it ever, legislate policies that will result in food shortages. Nor should Congress continue to permit an investment climate for nonfarm income that continues to lead to burdensome surpluses and the concentration of farming assets.

Can agriculture get by, remain productive, and assure the country of a dependable and affordable food supply without heavy reliance on outside capital? The Grange believes that it can. In fact, it is our contention that it must if dependability, productivity, and affordability of food is our goal.

Much controversey has been generated over a Senate-passed provision that would limit the use of cash accounting in agriculture. We believe that provision is a sound one in spite of the widespread use of cash accounting in family farming (used in the most traditional sense). Congress would be advised to "target" the use of cash accounting to those for whom it was intended. One feedlot operator in Texas recently estimated that sixty percent of the cattle in his feedlot were investor-owned. This trend has enabled feedlots to acquire certain scales of efficiency and expansion, but it has been the result of the cash accounting advantages to nonfarm investors who keep cattle coming into the lot in steady numbers. I would like to submit for the record two items. The first is an article published in the Summer, 1983, edition of the Journal of Agricultural Law and Taxation entitled "Planning Ideas Using the Tax Deferral Benefits of Cattle Feeding." The seond item is a statement prepared for Workshop on Credit and Tax Policies of the Senate Small Business Committee, April 27, 1983, by Don Reeves.

The effect of efficiencies in the cattle feeding industry likely pass little benefit on to the cattle raisers, and some contend that it ultimately hurts their business. Nonfarm investors who sell those fat cattle are fairly insulated from the profit motive other than that required by IRS in order to show profit intent. This clearly has an effect on the farmer who feeds his cattle for profit. We question how any reduction in a cattle feeder's profit motive can lead to productivity in the industry's long-term best interest.

Other examples of tax sheltering in agriculture will be submitted for this hearing record by those more knowledgable in the area than I. The Grange simply contends that if and when agriculture becomes addicted to nonfarm capital to keep the industry afloat, productivity will decline. The decline will be even more dramatic if the capital inflow is shelter-oriented.

STATEMENT OF GRACE ELLEN RICE, ASSISTANT DIRECTOR, NATIONAL AFFAIRS DIVISION, AMERICAN FARM BUREAU FEDERATION, WASHINGTON, DC

Ms. RICE. Mr. Chairman, we appreciate the chance to be before the subcommittee today, particularly to look at the focus of tax policy on agricultural productivity. It is a question that we don't have precise answers to yet, and we hope that they will be developed at some point. The one thing that we do know is that the Tax Code is not neutral when it comes to the decisions that farmers do make.

One point I would like to make before I continue with the statement is that, when we are talking about agricultural productivity, it is from the standpoint of output to input, the ratio of farm inputs and the agricultural output.

The Federal tax system and the Farm Bureau more or less grew up earlier in this century, although not necessarily traveling along the same philosophies or paths. Ever since Farm Bureau's founding in 1919 we have expressed strong statements on the issue of taxes, and that policy has been developed by producer-members at the county, State, and national levels.

If you take a look at some of the statistics that deal with agricultural productivity, you would see that agricultural productivity has nearly tripled since the early 1930's. Much of this growth in productivity has been due to advanced technology that has been researched and developed.

Farmers throughout the country have certainly benefited from this.

Let me take a side point for a moment, though, and digress from the issue of productivity, and state that the Farm Bureau's No. 1 goal, as articulated by Bob Delano who is our national president, is to increase farmers' net income. And certainly, if you look at the Tax Code, it does have an effect on farmers' net income, whether it is through the use of investment credits or deductions for depreciation.

The Tax Code is a very powerful tool of behavior modification, and it does have an effect upon whether you are going to incorporate, whether you maintain your business as a sole proprietor, whether you sell livestock or crops this year or next year, and whether or not outside capital comes into agriculture as a tax shelter.

While tax policy, we believe, does have a direct effect on a farmer's income, we don't know exactly what its effect is upon agricultural productivity. The important part that tax policy does play, though, as far as agricultural productivity goes is its effect on the three components of land, labor, and capital.

If you are looking at land, you would probably have to say that if there is a direct effect on agricultural productivity water it would be upon that particular input of land, whether or not it is expensing for soil and water conservation expenditures or perhaps an investment credit for soil and water conservation expenses.

If you look at the capital assets, obviously that comes in terms of depreciation and the investment tax credit.

Looking at the third component of labor, I am going to refer to some of the statements that John Motley made concerning payroll taxes. We see very few tax incentives for labor in the Tax Code; in fact, what we see is mostly disincentives and it comes through the areas of payroll taxes and also through some of the minimum-wage laws. We would urge the subcommittee to take an additional look at that at some point.

These are primary examples of disincentives to doing business.

Much has been written about cash-basis accounting and preferential capital gains treatment. The Farm Bureau certainly has supported these provisions over the years and, if I may, let me quote for a moment from policy some diverse points that we make:

> We believe farmers should continue to be able to select either the cash or the accrual method of filing income tax returns. We oppose the use of agricultural land as a long-term tax-sheltered investment by pension and profit sharing funds. Farm Bureau favors maintaining the permanent status of the investment tax credit.
>
> The tax treatment of capital gains should encourage investment Without creating tax loopholes or discouraging the sale of property.
>
> We favor repeal of the Federal Estate Tax, and we oppose preferential tax treatment of foreign investments in agricultural land under Federal tax law or treaty provisions.

That gives you some idea of the breadth of our concern as far as tax policy goes, but returning to the narrow focus, the question of the effect of tax policy on agricultural productivity, we would have to say that agricultural research and development have been the primary growth areas in agriculture on this issue.

To the extent that the Tax Code provides an incentive for either individuals or companies to put forth effort for new research and development of products, to that extent productivity has and will continue to increase.

To conclude, we don't believe that there has been a direct effect of tax policy on agricultural productivity. We believe that the effect has been indirect but that tax policy certainly affects the mix of the resources used in agriculture.

I would conclude by saying that we do hope that the subcommittee in additional hearings will look at some of these other areas. I know there is a great concern about tax shelters, and we share that concern.

Getting back to agricultural productivity, we don't know what the precise effect is, and we would encourage the subcommittee to look at that further.

Senator GRASSLEY. Mr. Senter.

[Ms. Rice's written prepared testimony follows:]

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION
TO THE SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE
SENATE COMMITTEE ON FINANCE
REGARDING THE EFFECT OF THE FEDERAL TAX SYSTEM
ON AGRICULTURAL PRODUCTIVITY

Presented by
Grace Ellen Rice, Assistant Director, National Affairs Division

May 21, 1984

Mr. Chairman, Farm Bureau appreciates the opportunity to appear before the Subcommittee today to discuss the effect that our tax system has on agricultural productivity. This is a complex subject. One thing that we do know is that the tax code is not neutral when it comes to affecting business decisions by farmers. The question posed by this Committee is probably the most difficult one to answer with any degree of precision. Our statement today will, in the absence of solid evidence, be a review of the logic of the relationship between tax policy and agricultural productivity. We want to make sure that you understand our definition of productivity as the ratio of output to input.

The federal income tax system and the Farm Bureau grew up in the same decade earlier in this century. The Revenue Act of 1913 was enacted to provide a more reliable source of funding for the federal government. Farm Bureau was founded in 1919 to provide farm and ranch families with the opportunity for united action to achieve educational improvement, economic opportunity, and social advancement. Ever since those early years, Farm Bureau has expressed strong policy statements about the federal tax system. Farm Bureau's 1984 policy, which was developed by producer members in the county organization and approved at the state and national levels, represents the position of over three million Farm Bureau member families throughout the country. Our tax policy is included in its entirety at the conclusion of this statement.

As the Subcommittee considers the effect of tax policy on agricultural productivity, it may be useful to review statistics associated with productivity. The 1984 Fact Book of U.S. Agriculture (USDA) gives us the following information about agricultural productivity:

(1) U.S. farmers produce 14 times more per work-hour than they did in 1930 and 3.4 times more per work-hour than in 1960.

(2) Ten years ago one farm worker supplied the food and fiber needs of 50 people. Today, the figure has grown to 76.

(3) Technology, heralded by such developments as hybrid seeds, fertilizers, feed concentrates, mechanization, agricultural chemicals, and computers, has contributed significantly to

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the growth of productivity. These developments led to a transition from labor intensive agriculture to capital intensive agriculture. For example, in 1982, purchased inputs such as feed, seed and fertilizer were 2.6 times those of 1930, while farm labor input was only 19 percent of the 1930 farm employment figure. Overall, the farm sector is 2.5 times as productive as it was in 1930, although the agricultural resource base has not changed substantially since then.

(4) Current farm productivity means that Americans spend only 16 percent of their disposable income for a wide variety of wholesome foods.

American Farm Bureau Federation President Robert B. Delano has articulated the number one goal of Farm Bureau as the improvement of farmers' net income. Farmers are in business to make a profit. It goes without saying that the amount of net farm income is determined, in part, by federal tax laws. These laws are significant tools of behavior modification that affect the business decisions of farmers and small business owners throughout the country. For example, tax considerations may provide the primary incentives for changing the structure of a farming operation, the timing of crop and livestock sales, the purchase of new farm equipment, and the enticement of capital into production agriculture for tax shelter purposes.

While tax policy may substantially affect a farmer's income, what effect does tax policy have on agricultural productivity? The important effect of tax policy has been its treatment of the principal production components of land, labor, and capital. These components, in turn, determine the potential for agricultural productivity gains.

Tax incentives for these components have an indirect relationship to productivity. Tax policy affecting the land base would include such provisions as the expensing of soil and water conservation expenditures and the possible enactment of an additional investment tax credit for certain soil and water conservation expenses. If tax policy has any direct effect on productivity, it would more likely be seen in the improvements to the natural resources that are the basic components of agriculture. The incentives for capital expenditures, of course, lie in the areas of the investment credit and accelerated cost recovery (depreciation). With regard to labor, there are very few tax incentives. In fact, most farmers have attempted to reduce the number of farm laborers to some extent because of the payroll taxes they must pay and the burdensome paperwork required of farm employers. The minimum wage law also gave impetus to farmers to reduce labor inputs and substitute capital. These are good examples of how tax policy and regulations can be discentives and distort the use of productive assets.

Much has been written about the tax treatment of agriculture including the cash method of accounting, capital gains treatment for

certain farm assets, depreciation schedules, and the use of investment credits. Farm Bureau has supported these provisions over the years. There is no question that the use of such provisions has meant favorable treatment for farmers by reducing tax liability through credits and deductions and, in some instances, encouraging farmers to expand their farming operations. On the other hand, prior to the estate tax reforms of 1976 and 1981, the effects of estate tax policy and inflation placed farmers at a decided disadvantage in preserving their business operations for future generations.

Agricultural research and development have a more significant effect on productivity than tax policy. Research has been and will be the key to increased productivity. Both public and private research has led to the developments that have brought us enhancement and preservation of our soil and water resources and development of mechanization and agrichemicals that cut down on labor costs. The major part played by tax policy in this process has been the incentives for private companies and individuals to develop these breakthroughs in productivity-increasing research. To the extent the tax code encourages research and development, productivity will increase.

To conclude, we do not believe that tax policy has any direct bearing upon agricultural productivity per se, but tax policy certainly affects the mix of resources used in production agriculture. Its relationship is indirect in that it affects decisions concerning the use or improvement of land, capital, and labor.

We believe that the need exists for additional research to quantify issues surrounding agricultural productivity and the effects of tax policy. We have seen no numbers that might assist us in determining the effects of tax policy on farming. Any study should also address the concern that the tax incentives for risk taking in agriculture have become havens for guaranteed tax shelters. Other essential questions that must be dealt with include "Are we in production agriculture now being adversely affected by tax code provisions originally designed to help? Has agriculture production become over-stimulated by the tax code to the detriment of commodity prices and net farm income?" We don't know the answers to these questions and urge the Subcommittee to request research into this issue.

We look forward to more discussion of these concerns during this hearing. The Subcommittee has chosen an especially timely topic given the upcoming development of the 1985 farm bill.

Thank you for the opportunity to participate today.

--SUMMARY--

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION
TO THE SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE
SENATE COMMITTEE ON FINANCE
REGARDING THE EFFECT OF THE FEDERAL TAX SYSTEM
ON AGRICULTURAL PRODUCTIVITY

Presented by
Grace Ellen Rice, Assistant Director, National Affairs Division

May 21, 1984

1. The relationship between agricultural productivity, i.e. the ratio of output to input, and tax policy is not clear. The effect of tax policy has been primarily on the mix of resources used in agriculture. While tax policy may substantially affect a farmer's income through the use of deductions, credits, and other provisions, it does not have a direct bearing on agricultural productivity per se. Rather, the important effect of tax policy or productivity has been its influence on how farmers use the principal production components of land, labor, and capital. These components, in turn, determine the level of potential agricultural productivity. If tax policy has any direct effect on productivity, it would more likely be seen in the improvements to the natural resources that are the basic components of agriculture.

2. Much has been written about the tax treatment of agriculture including the cash method of accounting, capital gains treatment for certain farm assets, depreciation schedules, and the use of investment credits. Farm Bureau has supported these provisions over the years. There is no question that the use of such provisions has meant favorable treatment for farmers by reducing tax liability through credits and deductions and, in some instances, the encouragement of farmers to expand their farming operations or non-farm investors to enter agriculture. On the other hand, prior to the estate tax reforms of 1976 and 1981, the effects of estate tax policy and inflation placed farmers at a decided disadvantage in preserving their business operations for future generations.

3. Agricultural research and development have a more significant effect on productivity than tax policy. The major part played by tax policy has been the incentives for private companies and individuals to develop these breakthroughs in productivity-increasing research. To the extent the tax code encourages research and development, productivity will increase if there are sufficient economic incentives to adopt new technologies and markets expand.

4. Farm Bureau believes that the need exists for additional research to quantify issues surrounding agricultural productivity and the effect of tax policy. We have seen no data that might assist us and the Congress in measuring the effects of tax policy on farming.

INCOME TAXES

"Tax policy should be designed to encourage private initiative and economic growth.

"We support income tax indexing.

"We oppose a freeze or cap on scheduled tax cuts.

"When income tax cuts are considered, reductions in tax rates are preferable to changes in the tax laws which reduce the number of taxpayers. We recommend that any tax cut be accompanied by a comparable cut in government spending.

"Farm Bureau should closely monitor "flat rate" tax proposals to determine the feasibility and desirability of adopting this concept of income taxation and provide information on the flat rate tax to the state Farm Bureaus.

"Internal Revenue Service investigative procedures should ensure that individuals are made aware of their rights and are notified of proposed actions prior to any action which might infringe on those rights.

"We support legislation to preserve the confidentiality of federal income tax returns and to prohibit access to them and the use of information from them for any purpose unless such action is authorized by an appropriate court order.

"Taxpayers should be given the option to treat investment in capital equipment for the abatement of air, water and soil pollution as a current expense for federal income tax purposes since such investments generally increase costs without increasing production.

"Additional tax credits should be provided to industries which are required to comply with OSHA regulations, including standards more stringent than those adopted at the federal level.

"Since many taxpayers receive employer-financed hospital and medical insurance as a tax-free benefit, we recommend that other taxpayers be permitted an income tax deduction or credit for the cost of their health insurance premiums.

"We favor continuation of the current tax-exempt status of the interest on state and local bonds.

"We support an income tax credit for the parents of students enrolled in post-secondary education.

"We recommend that changes be made in the income tax laws to allow farmers who have incurred losses due to declared natural disasters to be allowed to apply for the carry forward provisions of the internal revenue code until the loss is completely written off within a maximum of 10 years.

"We oppose efforts to require farm employers to withhold income taxes from farm workers' earnings.

"We oppose the taxing of interest income as it accrues. We recommend that, to encourage savings, the federal tax exclusion for interest and dividends be increased to $1,000 for individual returns or $2,000 for a joint return.

"We believe farmers should continue to be able to select either the cash or accrual method of filing income tax returns.

"The alternative minimum tax provisions of the Internal Revenue Code can result in a higher income taxes for farmers who have capital gains. This tax cannot be reduced by the investment tax credit. We support the repeal of the alternative minimum tax provisions.

"We support repeal of the requirement for farmers to file 1099 forms; otherwise, seek to increase the reporting level from $600 to $5,000.

"We oppose the use of agricultural land as a long-term, tax-sheltered investment by pension and profit-sharing funds.

"We urge that the Internal Revenue Service abide by the decisions of state and local officials as to which agricultural lands shall be preserved in farm use through use of tax-deductible contributions of voluntary, private conservation easements.

"We believe the Internal Revenue Code (Sec. 163) should be amended to permit farmers and ranchers, whether on cash or accrual basis of accounting, to deduct interest payments on farm loans as an expense item whether the interest payment is made with funds obtained from the original creditor through a second loan, an advance or other financial arrangement similar to a loan or from funds secured from a second creditor."

INVESTMENT CREDIT

"Farm Bureau favors maintaining the permanent status of the investment tax credit. We should work to secure the investment credit on facilities used in agricultural production.

"We favor allowing investment credit on qualified used assets purchased by a lineal descendant but not on property that is repurchased by the previous owner.

"We support an amendment to the Internal Revenue Code to provide an investment tax credit for horses used for breeding and working purposes."

CAPITAL GAINS

"The tax treatment of capital gains should encourage investment without creating tax loopholes or discouraging the sale of property. The present law results in the taxation of "gains" which reflect, in part, a decline in the value of the dollar. We favor retention of the present minimum holding period.

"We support an exemption from the capital gains tax when a farm is sold and another farm purchased within 18 months after the original sale.

"When farmers are forced by government regulation or condemnation to sell land, buildings, livestock or other production items, they should be exempt from tax on the proceeds from such sale, provided they have owned the farm for five or more years and have derived at least half their income from farming for at least five years. Property owners affected by eminent domain should be given the option of replacing the condemned property or reporting the taxable gain over a period of years.

"We oppose proposals to apply the capital gains tax to the appreciated value of property transferred by reason of the death of the owner.

"We support the present law with respect to capital gains treatment for sales of breeding livestock and forestry products.

"We favor legislation that would reduce capital gains taxes for-retiring farmers who sell their farms to farmers and finance the farms themselves."

FEDERAL ESTATE TAXES

"We favor repeal of the federal estate tax. Pending repeal, federal estate tax exemptions or credits subsequent to 1987 should be indexed by the change in the Consumer Price Index.

"We oppose efforts to freeze scheduled increases in estate tax credits (exemptions) before they become fully effective.

"We oppose tax law or Internal Revenue Service regulations that provide for the recapture of estate tax benefits under special use valuation when heirs conduct necessary husbandry practices in their timber stands.

"We will support legislation to permit a full "credit for state death taxes" in determining federal estate tax liability where state death taxes are paid in installments."

SALES AND EXCISE TAXES

"The retail sales tax should be reserved to state and local governments.

"Federal excise taxes should be limited to:

"(1) Nonessentials; and

"(2) User taxes, such as the tax on passenger transportation by air and taxes committed to the federal Highway Trust Fund.

"We support the exemption of agricultural aircraft fuel from the federal airport and airway taxes. We oppose the use of funds collected as taxes on aircraft fuels for purposes other than improvement of the nation's airways.

"We oppose any additional tax on any farm commodity.

"We oppose the adoption of a federal value-added tax.

"We recommend that the excise tax on sales of well head oil be removed. Until this is accomplished, we support an exemption of 10 barrels of production per day for the royalty owner."

-- ADDITIONAL POLICIES HAVING TAX IMPLICATIONS --

CONSERVATION PROGRAMS

"We recognize the importance of maintaining a productive soil resource. We believe this can best be accomplished through voluntary programs using cost-sharing and tax incentives...

* * * * *

"We recommend a federal program of cost-sharing through income tax credits for soil and water conservation practices and structures which contribute to enduring conservation and environmental enhancement by reducing the discharge of soil particles."

FOREIGN INVESTMENT

"(1) Oppose preferential tax treatment of foreign investments in agricultural land under federal tax law or treaty provisions;

"(2) Insist that all foreign investors be required to conform to all U.S. tax laws;

"(3) Seek rules to require a special tax to compensate the United States for the income taxes bypassed when a foreigner produces agricultural products for export and receives payment in a foreign country."

STATEMENT OF DAVID SENTER, DIRECTOR, WASHINGTON OFFICE, AMERICAN AGRICULTURE MOVEMENT, WASHINGTON, DC

Mr. SENTER. Thank you, Mr. Chairman.

I appreciate the opportunity to appear before this committee on behalf of the American Agriculture Movement. It is our first appearance before a tax committee, but we feel that it is important that we start dealing with some of the issues that are affecting family farmers' ability to stay on the land.

We believe there are several unfair tax situations that exist in agriculture today. We are seeing a huge influx of corporations and investors that are farming the tax loopholes for their own gains. Billions of dollars are being lost through operators actually farming for a loss. Foreign corporations, investment groups, insurance companies, and a whole host of others are taking advantage of these tax shelters.

We do not believe that the Government is getting their dollars' worth in productivity gains that are being lost through these agriculture tax shelters.

Just last week I was in Kansas and went by a farming operation that had 70 circle pivot irrigation systems on it, and over the last few years every 2 years that whole setup is selling to another corporation so that they can maintain all investment tax credits and shelters on it and are actually farming to lose money over the last few years.

The American Agriculture Movement believes that a close look should be taken at putting a cap on the amount of dollars that can be written off by businesses getting a majority of their income outside of farming. When you get right down to it, Mr. Chairman, these are the same people that do not want supply management, the same people who want to continue to expand production.

We believe that a major part of the cost of the 1985 farm bill can be paid for by new revenue generated from closing these agriculture tax loopholes.

We urge this committee to encourage a study to determine the exact impact on our treasury and exactly what is being lost, written off, through these tax shelters each year.

I hope that at a future time I might be back before this committee trying to solve the tax problem of farmers; but in recent years, by selling below the cost of production, paying taxes has not been a major concern of farmers. But we do feel that changes such as this will give us a better atmosphere in order to continue to be the best and most productive producers of any sector of the economy.

Thank you for the opportunity to appear.

[Mr. Senter's written prepared statement follows:]

American Agriculture Movement, Inc.
100 Maryland Ave., N.E., Suite 500A, Box 69, Washington, D.C. 20002
(202) 544-5750

TESTIMONY FOR

DAVID SENTER, NATIONAL DIRECTOR

AMERICAN AGRICULTURE MOVEMENT, INC.

ON

IMPACT ON THE TAX SYSTEM

PRODUCTIVITY IN SMALL BUSINESS AND AGRICULTURE

MONDAY, MAY 21, 1984

BEFORE

THE UNITED STATES SENATE COMMITTEE ON FINANCE

SUBCOMMITTEE ON

OVERSIGHT OF THE INTERNAL REVENUE SERVICE

Strength From The Land

Mr. Chairman, and Members of this Committee, the American Agriculture Movement, Inc. feels there are several unfair tax situations that exist in agriculture today. This statement may be brief, but we feel this issue is an important one.

Agriculture is seeing a huge influx of corporations and investors that are farming the tax loopholes for their own gain. Billions of dollars are being lost by I.R.S. through operators 'farming for a loss'. Foreign corporations, investment groups, insurance companies, and domestic corporations are taking advantage of these loopholes.

The AAM believes a close look should be taken at putting a cap on the amount of dollars that can be written off by businesses getting a majority of their income outside of farming. We find the family farmers struggling to pay taxes to keep their schools and towns in business. While 'outside interest groups' don't have any reason to aid in the survival of the rural community.

We have heard many times that large corporations can 'farm cheaper'. But I doubt it, especially if large corporate farmers had to play by the same rules.

When you get right down to it Mr. Chairman, these are the same people that do not want supply management; want to continue to expand production, and have no concern for soil and water conservation programs. AAM believes a portion of the cost of the 1985 farm bill could be paid for by new revenue generated from closing these tax loopholes.

We urge this committee to encourage a study to determine the impact on our treasury. Mr. Chairman, I would hope at a future date to be back before this committee to aid in the solution of farmers tax problems. I would like to point out, when farmers sell below the cost of production, they owe IRS very little money. IRS figures show in 1982 there was no taxable agriculture income!

Thank you, Mr. Chairman, for the opportunity to appear before this committee. AAM, Inc. will be glad to answer any questions on this subject.

Senator GRASSLEY. Thank you all very much. Again, I have several questions that I want to ask, and I would ask all of you to respond as you feel moved, and feel like you have some experience that will lend itself to our having the best of information on this subject.

The first would deal with whether or not the tax incentives are more efficient than direct spending programs as a way of accomplishing the goals, whatever goals, we want to accomplish and which you feel are the least intrusive.

Mr. MILLER. Senator, if I might respond to that, I don't think there is any question but what, by directing your policies in the taxation of profits of agricultural production, more direct and efficient aid can be generated to those whom the legislation would speak to.

Our issue with how this is working in the present time is the lack of targeting those tax angles to an appropriate sector of agriculture. And I recognize that when I say that I am opening myself for a question or two later on, I'm sure.

But it would seem to us that as our farm bills have all stated, their policy is to support the family farm, I would certainly hope that in reviewing the tax aspect of agriculture that we could do the same thing. I think we could do a better job in terms of targeting the benefits of that tax package to the moderate scale, the efficient-size operation, without drawing undue pressure I think for direct Federal program subsidies to whomever.

I agree. I think the tax system is a much more efficient way to get at that.

Ms. RICE. Mr. Chairman, I guess our comment on that would be that if you look at either direct spending or tax incentives, tax incentives would probably provide the producer with more individual decisionmaking as to whether or not they take advantage of that tax incentive. And they could do that regardless of whether or not they were participating in any Government farm program.

As far as which tool might be least obtrusive or intrusive, that would probably be along the lines of an investment tax credit.

Senator GRASSLEY. Mr. Senter.

Mr. SENTER. I would concur with the comments of Mr. Miller, in that many times programs are placed in the law with regard to farm operators to provide tax incentives for the operation, but then it is written in so that a lot of other interests get access to that

program and actually reduce their tax liabilities from a whole host of other things through moving in to agriculture and under these tax shelters. The targeting would be a way to stop a lot of that.

Also, I would think that most of your family farm operators do not have the finances to have tax advisors and a lot of professionals involved in it. And many times programs become too complicated for the family-type farm operator to get access to them, where corporations and such, they have people who spend full time figuring out how to use these programs.

So I think they have to be simplified as much as possible and targeted so that they benefit those that they were intended to benefit.

Senator GRASSLEY. Does our current tax system benefit the person in the middle—we can refer to them as middlemen, I guess—at the expense of producers?

And I suppose that would relate as much to the problem we have in agriculture of successful marketing. That is as much of a problem as anything and probably one that we don't spend enough time on.

I guess I am asking the question in regard to the tax policies affecting the person in the middle as opposed to the producer.

Mr. MILLER. Senator, as I understand your question, are you asking about the moderate-scale producer, how that tax policy would affect the moderate-scale producer?

Senator GRASSLEY. Most of my questioning is geared toward what you and all of us would understand as the family farmer. That might vary—you know, the acreage might vary—but the person doing the management, creating his capital, either borrowing or his own capital, and marketing and providing the labor. Those are the four aspects of the family farm.

Mr. MILLER. I would speculate that those in the middle section, what we refer to as the disappearing middle, because I think that those moderate-scale producers are feeling pinches now that are almost immune at the top and at the lower-production scale that we have identified, that moderate-scale producer is one who is trying to make the most of his own labor. And when you have a tax policy that encourages investment in capital, which would substitute for that labor, then I think that he is probably faced with the decision: Do I take the plunge? Or do I continue to operate with the scale that I am and continue to rely on as much labor as is possible?

It seems to us that one of the things that most directly opens up a moderate-scale producer for financial trouble is overreliance on borrowed capital.

Senator GRASSLEY. Stop just a minute. I have to consult with staff, because I think we got the question wrong.

[Pause.]

Senator GRASSLEY. We aren't talking about the producer; we are talking about marketing of the product produced on the farm, post-production, and the extent to which there are tax incentives available to people at that level to the detriment of agriculture and productivity within agriculture, and whether or not we ought to be gearing our tax policy toward the elimination of that or toward the more direct marketing of the agriculture product from the producer to the consumer.

Mr. MILLER. Senator, I would like to spend some more time thinking about that. That is an interesting aspect, and I am not sure it really has been given attention.

Senator GRASSLEY. You could submit an answer in writing.

Mr. MILLER. Thank you.

Senator GRASSLEY. Did I make it clear what my question is, Grace Ellen?

Ms. RICE. Yes, sir. And I think I would have to go along with Jim and say we would like to submit an answer in writing to that.

If I could, I would like to go back to the question that Jim was addressing, the effect on the middle portion of farmers in the country.

Senator GRASSLEY. Sure.

Ms. RICE. I think the statement was made earlier that the majority of farmers, in fact 88 percent of the farmers, in this country are sole proprietors and are functioning very much like a middle class of farmers, which they are. And I think that those farmers come up against the same walls that middle-income taxpayers across the country do.

If you look at the individual income tax rate cuts that went into effect a couple of years ago in 1981, I think that those types of changes in tax policy, those reductions, made it a little bit easier on farmers.

As far as deriving any kind of change from a labor-intensive agriculture to a capital-intensive agriculture, I think in many instances it is hard to find the labor to do the farm work, even on a small-size farm.

I know my family farms down in Arkansas. It's a relatively small farm, and at any one time we have maybe four or five hired people on the farm. Yet it is very tough to find those people.

So I don't believe it is necessarily mechanization or any kind of capital expenditure that has led away from a labor-intensive agriculture; I think the availability of labor as far as the payroll tax issue has something to do with that, too.

Mr. SENTER. Our organization would be very interested in pursuing and taking a close look at what the impact would be on targeting some tax policy to encourage and promote direct marketing from the producer to the consumer.

We have always felt that producers needed to market more of their product to the ultimate consumer, and this could be a way to help producers through some shifts in the policy and at the same time provide the consumers with some alternatives in where they purchase and what they purchase.

Mr. MILLER. Senator, excuse me for just a minute.

I think that your question is very well taken, and it has gotten to the point where I have and would like to submit for the record, with your permission, two items. One is a statement prepared by a gentleman named Don Reaves, who is a farmer from Nebraska. This was developed in conjunction with a workshop that was done on credit and tax policies for the U.S. Committee on Small Business. And to my knowledge there was not a proceedings of that workshop.

I would like to submit this, because it is very interesting. What he does is, he takes a look at some of the marketing incentives and how that tax policy is also impacting that.

I also have an article taken from the Journal of Agricultural Taxation and Law entitled "Planning Ideas Using the Tax Deferral Benefits of Cattle Feeding." It is interesting if for only one purpose—it makes the point in two separate places in the article that any investments in cattle feeding must be demonstrated to have a profit motive, and I think by having to point that out twice in a 10-page article, it indicates that the tax deferral benefits are so attractive that we must remember that in order to prove to IRS what we are doing this for we have to try to make some money at it. I think in that case the tax deferral does have an impact on marketing decisions, that consequently have impacts upon marketing decisions by those who are trying to do it for a living as well.

[The statement by Don Reaves and the article from the Journal of Agricultural Taxation and Law follow:]

INTERRELIGIOUS
TASKFORCE ON US FOOD POLICY
110 MARYLAND AVENUE, NE, WASHINGTON, DC 20002 202/543-2800

Statement by Don Reeves
on behalf of
Interreligious Taskforce on US Food Policy
prepared for
Workshop on Credit and Tax Policies
United States Senate
Committee on Small Business

April 27, 1983

Federal tax policy . . . has led to upward pressure on farmland prices, larger farm sizes, incentives for farm incorporation, altered management practices, and increased use of farmland as a tax shelter--by both farmers and nonfarmers.

Charles Davenport, Michael D. Boehlje, David B.H. Martin. The Effects of Tax Policy on American Agriculture. Economic Research Service, US Department of Agriculture. Agricultural Economic Report No. 480.

I am Don Reeves. My wife, Barbara, and I are the senior partners in a two-family grain and livestock farming operation in Merrick County, Nebraska. With Neil and Kay Mesner, we tend 400 acres of irrigated cropland plus hogs and beef cattle. Aside from a few days exchange labor with neighbors, we and our children provide all the labor for this enterprise. It in turn provides a comfortable living for our two families (most seasons!).

I appear as a representative of the Interreligious Taskforce on US Food Policy, for whom I am Family Farm Consultant. The Taskforce is a team of Washington-based staff of national religious agencies who work together for a morally responsible US food policy. We speak for ourselves and not for the two dozen Protestant denominations and national Catholic, Jewish, ecumenical and other agencies which support and cooperate in our work. However, our statements are consonant with the public policy recommendations of our sponsoring groups.

We welcome this opportunity to take part in a dialogue on the impact of the federal tax code on family farms.

THE TASKFORCE IS A TEAM OF WASHINGTON-BASED STAFF OF NATIONAL RELIGIOUS AGENCIES. THESE BODIES OR THEIR PROGRAM BOARDS COOPERATE IN ITS WORK: AMERICAN BAPTIST CHURCHES, USA • AMERICAN JEWISH COMMITTEE • AMERICAN LUTHERAN CHURCH • BAPTIST JOINT COMMITTEE ON PUBLIC AFFAIRS • CHRISTIAN CHURCH (DISCIPLES OF CHRIST) • CHRISTIAN LIFE COMMISSION OF THE SOUTHERN BAPTIST CONVENTION • CHURCH OF THE BRETHREN • EPISCOPAL CHURCH • FRIENDS COMMITTEE ON NATIONAL LEGISLATION • JESUIT SOCIAL MINISTRIES • LUTHERAN CHURCH IN AMERICA • LUTHERAN CHURCH - MISSOURI SYNOD • MARYKNOLL FATHERS AND BROTHERS • MORAVIAN CHURCH IN AMERICA • NATIONAL COUNCIL OF CHURCHES AND CHURCH WORLD SERVICE • PRESBYTERIAN CHURCH IN THE US • REFORMED CHURCH IN AMERICA • UNION OF AMERICAN HEBREW CONGREGATIONS • UNITARIAN UNIVERSALIST ASSOCIATION • UNITARIAN UNIVERSALIST SERVICE COMMITTEE • UNITED CHURCH OF CHRIST • UNITED METHODIST CHURCH • UNITED PRESBYTERIAN CHURCH IN THE USA • BREAD FOR THE WORLD • CENTER OF CONCERN • NETWORK • WORLD HUNGER EDUCATION SERVICE. THE TASKFORCE, WHICH SPEAKS FOR ITSELF, PROVIDES INFORMATION AND RECOMMENDATIONS ON US FOOD POLICY TO ITS COOPERATING AGENCIES AND THE NATIONAL IMPACT NETWORK

Paul Kittlaus United Church of Christ Chair

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Introduction

There is an unspoken premise which I wish to affirm in the existence of the Small Business Subcommittee on Family Farms and in the convening of today's workshop. The premise is that family farms are important to the life of the nation, to the life of rural communities, and to the families who produce our nation's foodstuffs.

I could expand at great length, but I will note only that the importance of family farms is related primarily to quality of life and quality of citizenship, and has little to do with costs of producing foodstuffs. Modest size farms can be as efficient as very large farms in terms of per unit cost or labor efficiency. Very large farms, however, entail substantial human and social costs heretofore recognized in public policy rhetoric but mostly ignored by actual federal policy and program mechanisms. A full accounting of social and economic costs argues strongly for an agriculture based primarily on moderate-sized family farms.

The most appropriate public policy question, therefore, is "What is the greatest feasible number of family-operated farms?" rather than the more usual question, "How large can a farm be, and still be a family farm?" Policy judgments must be on the basis of their effect, not their intent.

Impact of Tax Expenditure Rules in the Federal Tax Code

It is my judgment that tax expenditures (tax breaks, tax loopholes) within the federal tax code--taxes not collected because of special rules--are the greatest single "driver" toward expansion of farms beyond moderate size. "Loopholes" in the income tax code, a differential tax rate for incorporated farms (even if family controlled), and special relief in the federal estate tax rates for closely-held businesses combine to encourage and subsidize the continual expansion of individual farms. Most of these benefits flow to larger farms and to investors with substantial nonfarm income.

Let me trace the effect of several tax breaks on four farmers in my community. John F. is a young farmer just getting started. Although his wife works, his starting up expenses are such that they have no current income tax liability--they are in a 0 percent marginal tax bracket.

I am, in fact, the second of my farmers. We have substantial equity in our farm, but are not debt free. Last year we were in the 25 percent marginal tax bracket, partly because Barbara works part-time as a nurse.

A neighbor, Leland G., is a bit farther along. His farm is larger and his debt load relatively less. He and his wife are in a 39 percent marginal tax bracket.

The fourth "farmer" is a well-established attorney. His professional income puts him in the 50 percent tax bracket--or would except for his farming "investments."

Table 1. Impact of selected tax provisions on selected taxpayers

Marginal Tax Bracket	0%	25%	39%	50%
Tax on $1,000 additional ordinary income/ After tax income	$0/ $1,000	$250/ $750	$390/ $610	$500/ $500
Tax reduction from $1,000 deductible expenditure	$0	$250	$390	$500
Tax on $1,000 capital gains/ After tax income	$0/ $1,000	$100/ $900	$156/ $844	$200/ $800
(value of conversion from ordinary income to capital gains)	($0)	($150)	($234)	($300)
Tax reduction for $1,000 expenditure eligible for investment tax credit	$0	$100	$100	$100

Now, imagine each of us receive an additional $1,000 income. After taxes, my young farmer would have the whole $1,000 for family expenses or debt retirement. Each of the others would have respectively less, with my attorney friend having only $500 (actually only $410--Nebraska income tax equals 18 percent of the federal tax). (See Table 1.)

This progressive schedule is, in my view, the way an income tax ought to work. If it actually worked, it would give a competitive edge to the younger beginning farmer as compared to the well-established farmer or my attorney friend.

Now consider deductions from taxable income. It is quickly apparent that the after-tax cost of these deductions equals the actual expenditure minus the tax which would otherwise have been paid. Borrowing money, for example, costs a 50 percent taxpayer only half (or less) as much as a nontaxpayer, so long as interest is an unlimited deduction.

This effect is magnified when the deductions do not represent actual expenditures (e.g., excess accelerated depreciation) or offsetting inventory adjustments are not made (e.g., cash accounting). Many of these deductions would presumably be offset by increased taxable income at a later date, but in the interim there is effectively an interest-free loan in the amount of the tax that has been deferred.

Some deductions from current income are permitted which are in reality capital investments (e.g., expenses of raising breeding livestock, certain land development expenditures). "Recapture" rules have been tightened in recent years, but there are still opportunities remaining in livestock and land development for the classic tax shelter--buying

and developing an asset with currently deductible expenditures, with later sale, if any, on a capital gain basis, only 40 percent of which is counted as taxable income. The comparative advantage of this conversion is, obviously, proportional to each tax bracket. This phenomenon, and resulting speculation, has been a major contributor to inflation in land value during the past twenty years.

Investment tax credit works somewhat differently, as a deduction from tax owed, rather than from taxable income. It treats all taxpayers equally but is meaningless to my younger, nontaxpaying neighbor.

Most of the income tax rules mentioned so far are business or across-the-board tax rules which also apply to farmers (rapid depreciation--accelerated cost recovery system, deductibility of interest, capital gain preference, and investment tax credit). Their application to farming is enhanced by three special farm tax rules--freedom to use cash accounting, deducting as cash expenses certain capital expenditures, and capital gains treatment of breeding livestock.

So far as I know, relatively little work has been done to quantify the degree to which these tax rules effectively subsidize farm consolidation. There seems to be little disagreement, however, about the direction of their effect.

I expect, for example, substantial tax motivated purchases of farm equipment late this year and in 1984, as PIK grain is converted to cash, exposing farmers to income tax liability because there will not have been the normal offsetting deductible expenses. How many of these additional expenditures will in fact be a wise use of resources? How much of the tax savings will be bid into higher rents to fully utilize new, larger equipment, and thence into a new round of spiraling land prices? It seems clear that a great deal of previous tax benefits has been bid into land values; the unanswered question is how much. I suspect it may be a very high proportion.

Corporate Tax Rates and Farms

Tax rates for corporations are less, often substantially so, than for individual taxpayers through the income range that includes moderate and large family farms--those having taxable income greater than about $16,000. (See Table 2.) The differential tax rate becomes an incentive for corporations to accumulate and hold farm assets, especially land.

Little attention has been given to the difficulty of dis-incorporating, and the temptation under some circumstances to trade stock in family-held corporations for stock in larger corporations. I expect it to be an increasing phenomenon as first generation family corporations get transferred.

Table 2. Comparison between individual income tax rates and corporate tax rates

Taxable Income	Individual Rate (Married, filing jointly) (1983)	Corporate Rate (1983)
$0 - $3,400	0%	
3,401 - 5,500	11%	
5,501 - 7,600	13%	
7,601 - 11,900	15%	
11,901 - 16,000	17%	
16,001 - 20,200	19%	
20,201 - 24,600	23%	
24,601 - 29,900	26%	
29,901 - 35,200	30%	
35,201 - 45,800	35%	
0 - 50,000		*17%*
45,801 - 60,000	40%	
60,001 - 85,600	44%	
50,001 - 100,000		*20%*
85,601 - 109,400	48%	
>109,401	50%	
100,001 - 150,000		*30%*
150,001 - 200,000		*40%*
>200,000		*46%*

Estate Taxes

I think the schedule for increasing tax credits against estate and gift tax liability went quite beyond those necessary to allow for inflation, especially considering the current actual decline in farmland value. As a practical matter, the estate values listed in the statute may be doubled, when considering farm size, since most families will take the rather simple tax-planning step of dividing their property into two estates. Few farms with net assets of less than $1.2 million will be subject to estate tax when the current law is fully phased in, after 1986. This figure, moreover, does not consider annual pre-death gifts or other more complicated, but quite legal, steps that may be taken to reduce estate size.

More disturbing to me are the special estate tax provisions for closely held businesses, most of which are farms. Special use valuation will reduce the taxable value of farms for qualifying families by half or more in most circumstances. An extended payment schedule, with interest calculated at 4 percent, is also available for qualified estates. Note that these features benefit only farm estates large enough to be taxable, and their maximum benefits are available only to farm estates with net assets greater than $1 million (usually farms having more than $2 million net assets). Note also that indebtedness for farm assets is encouraged by special use valuation, since the value placed on farmland is reduced, but offsetting indebtedness is not. These features encourage farm

-- Incentive to incorporate, expand, leading to possible tax-free stock exchanges with a larger corporation.

-- Preference for farm property in larger estates.

-- Discouragement from sale of farm properties by retired farmers, or their heirs.

-- Reduced opportunity for younger, beginning farm families.

Possible Changes Toward a Tax Code Which Would Support Family Farms

Perhaps the first recommendation which must be made is for the public and private research establishment to recognize and measure the regressive effects of these various rules in a systematic and quantitative way. The following list of suggested policy changes to restore a progressive tax system should be taken, therefore, as an indication of the character and scope of changes which will be required of a tax code that will in fact support the goal of creating and maintaining family farms.

Income Tax Rules

1. Capital gains income should be taxed more severely. The most effective change would be to tax all realized capital gains as ordinary income. Somewhat less severely, capital gains might be indexed to inflation, with the gain attributable to inflation taxed at the existing preferred rate and all gain above inflation taxed as ordinary income. A supplemental change might be to limit, annually or by lifetime, the amount taxable as capital gains, with any excess taxed as ordinary income.

2. A carryover basis should be reestablished for determining capital gains for inherited property. In nearly all instances this would not affect inherited farms that stay in the family. It would remove one barrier to pre-death sales and transfers of farm assets.

3. Cash accounting privileges for farmers should be terminated or limited to moderate-sized farms. Cash accounting is the key provision enabling wealthy investors to maximize gains from most of the other tax rules enumerated. Most farmers already keep annual inventories which could be adapted to accrual accounting. Income tax averaging provisions will suffice to level taxation resulting from extreme year-to-year swings in income.

4. All expenditures to develop capital assets or increase their value should be capitalized and depreciated, if applicable, over the useful life of the asset.

5. Depreciation schedules for capital assets should approximate the real useful life of each asset, and at a rate which approximates actual decline in real value. Depreciation deducted from ordinary income should be recovered and taxed as ordinary income if a capital asset is sold for a gain.

families to hold on to estates which might otherwise be sold. It also encourages investors to build farm estates and to qualify themselves to be eligible for the special estate tax features.

Table 3. Schedule for phasing in increases in the unified credit against estate and gift taxes

Year	Credit	Equivalent Estate Value
1982	$62,800	$225,000
1983	79,300	275,000
1984	96,300	325,000
1985	121,800	400,000
1986	155,800	500,000
1987	192,800	600,000

Summary of Effects

As a summary of effects of these various tax rules, let me quote from a resolution adopted by the Nebraska Farmers Union in December 1982, as they appointed a tax study committee:

> Nearly every farmer takes some advantage of tax loopholes (technically "tax expenditures"; also called tax breaks) in the federal tax code. The large majority of these farm-related tax breaks go to farmers or farm investors who are in the high marginal income tax brackets. Tax breaks give these taxpayers an advantage in bidding for farm resources, when compared to beginning farmers, or families operating small and moderate-sized farms, who are usually in lower income tax brackets, or have no tax liability at all.
>
> We observe the following negative trends, which flow at least in part from the complex of federal tax breaks available to farmers:
>
> -- Encouragement of and subsidies to continual expansion in farm size.
>
> -- Incentives to invest in farmland or farming enterprises as a tax shelter.
>
> -- Inflation in farmland value.
>
> -- Overproduction of the most tax-favored commodities, and consequent lower farm commodity prices.
>
> -- Overinvestment in equipment; higher land rentals.
>
> -- Inefficient livestock practices (e.g., one-litter gilt/hog operations).

6. The Investment Tax Credit should be eliminated for livestock and farm buildings and probably farm equipment.

7. Unlimited deduction of interest as a farm business expense should be restricted to farmers active in the day-to-day operation of their farm.

8. Use of farm losses to offset taxable income from nonfarm sources should be prohibited for at least three classes of farmers:

   a. any corporation;

   b. any farmer who uses cash accounting; and

   c. any farmer whose principal livelihood arises from nonfarm sources (probably as measured by a nonfarm income test).

Corporation Tax Rules

All farmers should be taxed according to the same tax schedule. One approach would be to tax each incorporated farming operation as a partnership.

Estate Taxes

1. The 1981 inflation adjustment in the unified tax credit should be diminished and any future inflation adjustments in the credit and in the annual gift tax exclusion should be restrained.

2. A progressive estate tax schedule should be readopted for estates larger than $2.5 million.

3. Special use valuation for farm estates should be eliminated; especially by the time the increased tax credits are phased in. If special use valuation is retained in any form, qualifying heirs should meet a residency and maximum assets test.

4. The highly subsidized interest rate should be discontinued for any extended payment contract for estate tax. If such contracts are written, they should bear interest at the cost of money to the government, since the only users of such contracts are already wealthy families.

5. Repeating from the capital gains discussion, the carryover basis for inherited property should be reinstated.

Planning Ideas Using the Tax Deferral Benefits of Cattle Feeding

CLARK S. WILLINGHAM*

Cattle feeding is the major tax deferral shelter available today. Besides the obvious benefit of putting off the payment of tax liability to a future year, the investor also can arrange, with proper planning, to be taxed at lower levels, to qualify for capital gains taxation, and to set up favorable retirement and estate planning strategies.

Tax deferral in the hands of a good tax planner can be just as favorable a tax shelter as conversion of ordinary income into capital gains. The goal in tax planning with deferral shelters is to take the tax losses in a year of the taxpayer's highest marginal tax rates, but delay recognition of the corresponding taxable income to a year in which the tax rate is lower. Result: The same total dollars are taxed but at a lower rate.

The major deferral shelter available to investors today is cattle feeding. Most other major shelter ventures, however, also contain some element of deferral. In oil and gas, excess intangible drilling costs (IDC) is taxed, upon sale of the property, as ordinary income instead of capital gains. In real estate liquidations, the excess of accelerated depreciation over straight-line depreciation is likewise recaptured as ordinary income. In cattle breeding the entire amount of depreciation is recaptured as ordinary income upon sale of the herd.

How the Cattle Feeding Shelter Works

Cattle feeding works as a tax deferral investment because of the use of the cash-basis method of accounting and high leverage. Exhibit 1 illustrates how the cash method of accounting works in cattle

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EXHIBIT 1. How Cash Method Accounting Works in Cattle Feeding

To start his cattle-feeding venture, let's assume the "farmer" (taxpayer) invests $150 in cash and borrows an additional $600 from a bank, with full personal liability. Thus, the total cash available is $750.

With this $750 the farmer buys one steer for $425 and buys feed with the remaining $225.

The operations:	
Purchase one steer	$525
Feed, interest, etc.	225
Total cost	$750

When the steer is ready for slaughter, it is sold to a packing plant. Assuming the fattened steer sells for $750 cash, the farmer would then pay off the bank borrowings of $600 and have his $150 cash back. This example assumes a mere break-even situation. In practice, of course, there would probably be profits or losses.

Getting out:	
Cash from sale of fat animal	$750
Repayment of bank borrowings	600
Cash for farmer	$150

While the Economic Recovery Tax Act of 1981 (ERTA) made no changes, the Tax Reform Act of 1976 substantially changed the tax treatment of cattle feeding. "Farmers" may still deduct cattle feed in the year paid for, but "farm syndicates" must deduct feed only in the year in which the feed is consumed. In examining the tax consequences of the investment by a farmer using the cash method of accounting, we assume that the steer and feed are purchased in year 1, but the fattened steer is not sold until year 2. The farmer's first year tax return would, therefore, reflect an ordinary income loss of $225, which is the cost of feeding the steer. In year 2, he would sell the steer and show a gross sale income of $750. This amount would be reduced by the farmer's $525 basis, giving him a net taxable income from cattle feeding of $225. Obviously, the farmer didn't earn a $225 profit in year 2, nor did he lose $225 in year 1. By using the cash-basis method of accounting, and properly timing the income and expenses, the farmer has shifted income from year 1 to year 2. A farm syndicate can easily achieve the same tax treatment by purchasing the animal so that the bulk of the feed is actually consumed by year-end. The process could then be repeated by purchasing additional animals and feed to again defer taxable income to the next year.

The Tax Return	*Year 1*	*Year 2*
Purchase one steer	$ 0	$(525)
Feed, interest, etc.	(225)	0
Sale of fattened animal	0	750
Net profit	$(225)	$ 225

EXHIBIT 2. How Different Amounts of Leverage Affect Percentage Write-Off

The Tax Return	*Year 1*	*Year 2*
Purchase one steer	$ 0	$(425)
Feed, interest, etc.	(325)	0
Sale of fattened animal	0	750
Net profit	$325	$ 325

Now the write-off has been increased to 217 percent.

feeding. The examples in Exhibit 1 use a standard feedlot animal and achieve a 150 percent tax write-off. By starting earlier in the year with a lighter-weight animal, the write-off can be increased. Instead of buying a 650 pound steer for $525, consider what happens on the tax return of the farmer who purchases a 500 pound steer for $425 and feeds the animal over a longer time period. Exhibit 2 shows how different amounts of leverage affect the percentage write-off.

Both exhibits assume the investor invests $150 cash equity, which is a fairly general equity charged by the major agricultural lenders. Most ag banks will reduce the cash equity required to $100 per head once the cattle are "hedged" at break-even or better. Hedging involves using the cattle futures markets and can help reduce the market fluctuations inherent in the cattle industry. By using a $100 investment in hedged cattle in the Exhibit 2 example, the tax write-off is increased to 325 percent.

Some planners also advocate using letters of credit to further increase the tax write-off. With a $50 cash investment and a $100 irrevocable bank letter of credit, the tax write-off is 650 percent.

Practical Uses of Tax Deferral

In many situations investors simply do not want to pay taxes in the current year. High-leverage cattle feeding can allow the investor to postpone the current year's income tax liability by investing only a fraction of the taxable income—usually much less than the actual tax itself would be. This postponement can also be continued indefinitely, by simply continuing to feed cattle each year.

Another use for deferral is to buy time until the following year to allow the investor to get into a more suitable investment at that time. Cattle feeding works especially well in conjunction with real estate, which throws off moderate first-year losses but allows a continuing stream of losses in ensuing years. The taxpayer invests in cattle in year 1 to provide high multiple write-offs. During the phaseout of cattle, the cattle-feeding taxable income is offset with real estate losses.

Changing Rates

The classic planning situation using deferral is the one-time large gain where it is known that the taxpayer's income will not be as high in succeeding years. The example below illustrates the after-tax effect of a $20,000 investment generating a 200 percent write-off and a change in the tax rate from 50 percent to 30 percent.

	1983		*1984*	
Cash (invested) returned	($20,000)		$20,000	
Tax deduction (income)		$40,000		($40,000)
Taxes saved (paid)	20,000	50%	(12,000)	30%
Net cash (invested) returned	-0-		$ 8,000	
Total profit after taxes			$ 8,000	
Percent return on *gross* cash investment				40%

The previous example assumes the cattle venture is an economic break-even. As can be seen below, a 20 percent actual economic loss still results in a 26 percent after-tax profit based on the *gross* cash invested. Note that there would be no *net* cash invested.

	1983		*1984*	
Cash (invested) returned	($20,000)		$16,000	
Tax deduction (income)		$40,000		($36,000)
Taxes saved (paid)	20,000	50%	(10,800)	30%
Net cash (invested) returned	-0-		$ 5,200	
Total profit after taxes			$ 5,200	
Percent return on *gross* cash investment				26%

It must be emphasized again that the taxpayer must enter any tax shelter for *economic* profit in order to deduct the losses. Cattle feeding is a viable business, but it is also high risk. Investors should seek good operators and not structure the program so that the potential tax benefits outweigh the true economics.

Sheltering Long-Term Capital Gains

When working with long-term gains, investors must be careful to pick investments that do not show up on Schedule D of the tax return. Losses on Schedule D offset the long-term gain *before* the taxpayer gets to take the 60 percent deduction. Remember: Only try to shelter the 40 percent of the gain that is taxed as ordinary income.

Without Cattle:

	Investor's Cash	*Form 1040*	*Schedule D*	*Schedule F*
Sale of stock	$100,000		$100,000	
Long-term gain deduction			(60,000)	
Net gain taxable		$40,000	$ 40,000	
Tax (50%)	(20,000)			
Net cash	$ 80,000			

With Cattle:

	Investor's Cash	*Form 1040*	*Schedule D*	*Schedule F*
Sale of stock	$100,000		$100,000	
Long-term gain deduction			(60,000)	
Net gain taxable		$40,000	$ 40,000	
Investment in cattle	(20,000)			
Loss from cattle		(40,000)		($40,000)
Combined taxable income		-0-		
Taxes paid	-0-			
Net cash	$ 80,000			

The $20,000 investment has eliminated the ordinary tax resulting from the long-term capital gain. (But the taxpayer can never avoid the alternative minimum tax. The calculations in the example assume that tax does not apply. Take care always to check those calculations on a case-by-case basis.)

The cattle-feeding investment above is made entirely with tax dollars not paid to Uncle Sam. If the investor plans his exit from the cattle business to coincide with a lower tax bracket, he also benefits from the lower overall tax. Additionally, the investor has had the use of the $80,000 cash and its income-producing potential.

Retirement Planning

One surefire way to reduce tax rates is to stop working and reduce income. This obvious situation can lead to good tax planning if the investor knows in advance that he is going to retire. Cattle feeding can be used to shift income from the high bracket earning years to the lower bracket retirement years, as can be seen from the following example.

	Earning Years 50% Bracket		*Retirement Years 30% Bracket*			
	1	*2*	*3*	*4*	*5*	*6*
Cash investment	$20,000	$20,000	0	0	0	0
Cash returned (break-even)	0	0	($10,000)	($10,000)	($10,000)	($10,000)
Tax income (loss) at 200%	(40,000)	(40,000)	20,000	20,000	20,000	20,000
Tax paid (saved)	(20,000)	(20,000)	6,000	6,000	6,000	6,000
Net cash returned	-0-	-0-	($ 4,000)	($ 4,000)	($ 4,000)	($ 4,000)

The investor enjoys a $16,000 profit even if the cattle only break even, because he effectively pays tax on $80,000 at the 30 percent rate instead of the 50 percent rate. (The typical cattle-feeding venture serves to defer income for one year at a time. This example assumes the investor buys new cattle each year, to roll his income forward.)

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Estate Planning

Another practical application for cattle feeding is in estate planning for the elderly. Because of the step-up in basis rules, the income would, in effect, be deferred forever: The new stepped-up basis would include the value of the feeding cost already deducted on the decedent's tax return. Death, however, remains the harshest way to avoid taxes.

Assume an estate consisting of $300,000 of assets plus $300,000 of ordinary income:

Without Cattle Feeding:

		1983		*1987*
Taxable income		$300,000		$300,000
Income tax (50%)		(150,000)		(150,000)
Net cash to estate		$150,000		$150,000
Other assets		300,000		300,000
Taxable estate		450,000		450,000
Estate tax	$138,800		$138,800	
Unified credit	(79,300)	59,500	(192,800)	-0-
Net estate		$390,500		$450,000

With Cattle Feeding:

		1983		*1987*
Taxable income		-0-		-0-
Income tax (50%)		-0-		-0-
Net cash to estate		$300,000		$300,000
Other assets		300,000		300,000
Taxable estate		$600,000		$600,000
Estate tax	$192,800		$192,800	
Unified credit	(79,300)	113,500	(192,800)	-0-
Net estate		$486,500		$600,000
Tax savings		$ 96,000		$150,000

As can be seen from the above examples, deferring the income tax liability increases the net estate left after taxes. The taxable estate is increased by the amount of income tax not paid. This tax-planning technique is especially useful in smaller estates that are not large enough to take full advantage of the unified credit as illustrated in the 1987 figures above.

Conversion to Capital Gains

The previous examples dealt with the deferral available from a short one-turn cattle feeding venture (though some instances are enhanced by continued deferral). While multiple write-off deferrals are excellent tax-planning investments in many situations, most taxpayers would obviously prefer to have the deferred income ultimately taxed at the more favorable long-term capital gains rates. By entering into the cattle-feeding business on a long-term basis, conversion of ordinary loss into long-term capital gain is probably possible.

To do this, the feeding venture is started in year 1 in an S corporation. Losses from that first year's operation flow through to the individual and offset his income from other sources. On January 1 of year 2 the S corporation election is revoked. The corporation thus becomes a separate taxable entity. The 1983 rate of corporate tax will be 15 percent, 18 percent, 30 percent, and 40 percent progressively on each $25,000 of taxable income and 46 percent on all income in excess of $100,000.

	Year 1	*Year 2*	*Year 3*	*Year 4*
Cash invested	$ 200,000			
Tax (loss) income*	(400,000)	$40,000	$40,000	$40,000
Personal tax savings (50%)	(200,000)			
Corporate tax paid**		(6,450)	(6,450)	(6,450)
Net cash investment	$ -0-			

* This assumes a 200 percent write-off. Depending upon the leverage used, the multiple write-off may be increased.

** This example assumes that the lower surtax rates are available to this corporation.

The investor must meet the basis rules, of course. Section 1366(d) of the Internal Revenue Code limits deduction of losses in excess of the shareholder's basis in stock and debt of the corporation. If the shareholder invests only $200,000 in the corporation, he would

be able to deduct only $200,000 of the corporation's year 1 loss. To avoid this limit, the investor should incur personal debt. Cattle-feeding deals are generally highly leveraged. In our example above, in addition to the $200,000 cash investment, there would probably be about $800,000 in notes. Rather than having the S corporation do all the borrowing, the investor should personally take a note for $200,000 of this amount, immediately lending the funds to the S corporation.

After a "substantial portion" of the taxable income has been recognized at the corporate level (30 percent was "substantial" in the *Kelly*[1] case), the corporation should not be considered "collapsible," and therefore liquidation would be at long-term capital gains rates.

		Year 5
Cash returned (break-even)		$180,650*
Taxable income	$380,650†	
Tax (20%)		(76,130)
Net cash proceeds		$104,520
Initial net cash investment		-0-
Total net profit		$104,520
Effective tax rate‡		23.87%

* The $200,000 originally invested less the $19,350 corporate tax paid.

† Even though only $180,650 cash is distributed, the taxable income would be $380,650. The $200,000 difference is the excess tax write-off taken in year 1.

‡ The individual would pay $76,130 in tax, and the corporation would pay $19,350. Thus, the total taxes paid on $400,000 would be $95,480.

The above transaction results in a gain of $104,520, even though the actual cattle-feeding venture broke even economically. This result is achieved because the original $400,000 of taxable income is taxed at 23.87 percent instead of 50 percent. The lower effective rate is the product of the lower corporate tax rates on part of the income and the long-term capital gain upon liquidation.

Summary

Cattle feeding is just a deferral. But thoughtful planning around a solid economic program can convert that deferral into an excellent

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[1] Kelly v. Comm'r, 32 T.C. 135 (1959), *aff'd*, 293 F.2d 904 (5th Cir. 1961). In Rev. Rul. 72-48, 1972-1 C.B. 102, the Service agreed to follow *Kelly*.

tax shelter. Investors should carefully investigate the quality of management and experience available in the industry.

Investors should be especially cognizant of their status as a "farmer" or "farm syndicate" for federal income tax purposes. Farm syndicates may not prepay feed but rather must deduct it only when consumed by *their own* cattle. High multiple write-offs are still available if the farm syndicate starts the cattle-feeding venture early enough in the year (usually late summer to early fall). On the other hand a "farmer" can prepay feed on December 31.

THE MORE THINGS CHANGE . . .

"Can anybody remember when the times were not hard and money not scarce?"

—Ralph Waldo Emerson
Society and Solitude

Senator GRASSLEY. Would expensing of capital equipment help boost productivity? I mean beyond the $5,000 expensing that we permit right now.

Mr. MILLER. I am not sure I can answer that question right now. I think I would have to do a little bit more work into that, I'm afraid.

Ms. RICE. I don't think that expensing would increase productivity. I think that what it could do is increase production. And, again, we see the distinction, productivity being what you put in has some effect on what you get out of any endeavor.

The point was made in the previous panel that if you are let's say a newcomer to the business world or perhaps you are new in farming, your income is not really sufficient at the beginning that would warrant any kind of long-term deduction. You don't have the cash upfront. So it might be helpful to someone to have expensing.

But again, we don't believe that it has any direct effect upon the output of an acre of land, let's say.

Mr. SENTER. We would concur that we do not see how the expensing would directly impact the productivity. In certain instances it could benefit, but we do not see that it would impact on productivity.

Senator GRASSLEY. Is there anything about current tax policy in management decisions in agriculture that—well, let me start over again.

Because we change tax law so often, and because we have different approaches like land improvement expenses that are handled one way, and we have ACRS and the investment tax credit for some capital investment, do current tax provisions send mixed signals that are a detriment to productivity?

Mr. MILLER. Senator, I think they definitely send mixed signals, and I think I would agree with some of the previous panelists, too, that would indicate that there is this apprehension and a feeling that we don't know from 1 year to the next what is going to be happening with us; but if we look in terms of the accelerated depreciation on some single purpose agricultural structures, it is fairly obvious that the industry reacts quickly to those sorts of things.

We have witnessed it in what we perceive to be a tax motivated shift, particularly in the production of cork and to a lesser extent I think but equally demonstrated in the poultry industry.

Now, the poultry industry started integrating much before the enactment of accelerated depreciation; however, that integration has continued by leaps, I think, with the current policies.

Now, it does have the effect, obviously, of these farmers having a chance to modernize and update. And once that is accomplished and you have that structure on the land, then you can start recognizing your efficiency and your productivity immediately.

I think there is a point where we ought to put an end to it, however, because I think it is stimulating overproduction in some of the industries. I think that some of the proposals—to wit, one that was proposed in Kansas that would be a $33 million investment in pork production—probably are not being structured and submitted for demand purposes as much as they would be for the obvious tax

benefits in building that kind of facility, particularly if you had income from other sources that it could help offset.

Ms. RICE. There are mixed signals. For instance, the use of the investment tax credit naturally has stimulated purchase, let's say, of farm machinery or other capital equipment.

On the other hand, of course, prior to 1976 and then prior especially to 1981 you had an estate tax policy which had the exact opposite effect. Whereas someone may have used the ITC to have expanded their farming operation hoping to pass it down to their heirs, an estate tax policy on the other hand coupled with inflation had become a disincentive for that type of passing along your farming estate.

Another area not related to tax is the issue of fragile lands. You have the encouragement on one hand of preserving fragile lands, but yet farm program payments on the other which continue for farmers who do plow up fragile lands.

I am thinking of another instance now. It is a bill that we have no position on, but has been introduced in the House to limit the use of the investment tax credit for people who sign up for the dairy diversion program. That tax benefit or tax provision is still available, although the Government on the other hand is trying to hold down dairy production, at least for the next 15 months. So you do have paradoxes there. You do have mixed signals, and you have a disincentive to plan. There is no way you can plan if tax law is going to change every 18 months.

Mr. SENTER. I think most producers look at the tax system as the unknown, and it's kind of a dark cloud hanging out that it may rain tomorrow and then it may clear off tomorrow, that they look at it a lot like they do farm programs, because they never know when they are going to change but they know they are going to fairly soon.

As was pointed out, I think better coordination between tax policy, the impact on farm programs, and the whole productivity system needs to be looked at, because you can't have programs going different directions and have a program that will work smooth and be coordinated.

As was pointed out, the sodbuster legislation is going to take a step towards solving a major problem we've got at plowing out all this marginal land. But still the tax policy—they can write off expenses on clearing this land and changing the use.

So, better coordination would aid everyone in making sure that the policies all move in the right direction.

Senator GRASSLEY. I have no more questioning, but I would like to comment on an aspect of tax policy as it is related to what you said, about special-purpose agricultural buildings.

When I was in the House of Representatives, I was responding to family farmers in my State who, at that point, had built special-purpose agricultural buildings and were depreciating them in 5 years, based upon some legislative history of the 1972 tax law. Then they were finding themselves challenged by the IRS.

We were trying to respond to carrying out legislative intent, and so we legislated it more clearly in 1978, not anticipating that we would have $33-million investments, you know, and have overbuilding in agriculture—in pork production as an example.

And now, seeing what has happened, I think it is legitimate to change that. And we are responding to that situation in this current tax bill, because I think what we want to do is to encourage the farmers to be as productive as possible. But we don't want to encourage people who are nonfarmers to be involved in it for tax purposes to a point where the law of supply and demand and the cycles in the pork industry don't respond accordingly. And when they don't respond, then it is at that point that the family farmer is hurt.

The people who have the investment in the special purpose agriculture building generally keep those buildings filled to capacity—you just about have to or they don't function. So consequently, we distort the normal cycles and normal supply-and-demand cycles.

So we are trying to change it. We don't think we will affect the productivity of agriculture negatively as a result of that.

I think we could probably argue that if you get too much nonagricultural interests in agriculture, the productivity probably goes down as there is a less direct personal interest in what is going on.

That is the end of my questioning.

Mr. SENTER. Senator.

Senator GRASSLEY. Yes?

Mr. SENTER. One comment. Talking about some coordination, just recently in visiting with Congressman Stark on the House side—in 1978 legislation was passed and signed into law that placed capital gains tax on foreign investors. it brought them up to an equal status with domestic investors.

The State Department has put forward a proposal, about two months ago, calling for a repeal of the legislation that placed capital gains tax on foreign investors; they are pushing to make them tax-exempt again. So this fits right into what we were talking about, being coordinated. So, why would you want to remove the capital gains tax on foreign investors in agriculture land at the same time when they should be treated equally with domestic investors?

That is just another point where the Government needs to be coordinated in what they are doing.

Senator GRASSLEY. Let me know when that ugly beast surfaces, will you?

Mr. SENTER. I certainly will.

Senator GRASSLEY. Because as a proponent at that time of that change in the tax law so that the foreign investors would be treated no differently than domestic investors, or I should say American national investment, then I would obviously not want the State Department's recommendations to be successful.

Mr. SENTER. OK.

Senator GRASSLEY. Thank you.

The meeting is adjourned, and we would encourage everybody to keep in touch with us as these hearings progress next month as well.

Thank you.

[Whereupon, at 11:51 a.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

STATEMENT OF SIDNEY LIEBERSTEIN
MACHINERY DEALERS NATIONAL ASSOCIATION
BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE
MAY 21, 1984

I am Sidney Lieberstein, the immediate past president and the current Chairman of the Government Relations Committee of the Machinery Dealers National Association. I am also the President of Perfection Machinery Sales, Inc., 75 East Palatine Road, Wheeling, Illinois 60090. I am submitting this statement on behalf of the 500 MDNA member firms. We are small businesses which account for over 70 percent of the used machine tools sold in the United States. Because used capital equipment is acquired from large manufacturers and usually resold to small manufacturers, MDNA members are in the unique position to articulate the economic problems of the small business community. Our frequent contact with small manufacturers has led to MDNA becoming one of the recognized spokesmen for this group. Our statement concentrates on our concern about the impact on small business productivity of the limitation on the amount of used machinery and equipment which is eligible for the investment tax credit under our current tax system. We believe our concern is shared by all small businesses.

Under present law, there is a $125,000 limitation on the amount of used equipment eligible for the investment tax credit, but there is no limitation on the investment tax credit available for new equipment. This ceiling is scheduled to increase to $150,000 in 1985. (The tax bill which and is currently pending in Conference would defer this increase for four years until 1988.) Similarly, the same carryback/carryforward provisions available for new equipment are not allowed to purchasers of used equipment who may not carryforward or carryback tax credits on investment over the limitation amount.

Since the original $50,000 ceiling was established in 1962, the cost of basic, unsophisticated used equipment has generally increased by over 500 percent. It could cost over $600,000 to start a small machine shop which would employ ten people. If a large company which could afford to buy new equipment purchased $600,000 of equipment, it would receive an investment tax credit of $60,000 (10 percent of $600,000). If a small firm bought $600,000 of used equipment, it would receive an investment tax credit of $12,500 (10 percent of $125,000). In addition, purchasers of new equipment can carryback three years and forward fifteen years that part of the investment tax credit on the $600,000 purchase which cannot be used in the year of purchase. The small business which purchases used equipment can carryback and carryforward only the $12,500 which is allowed as a result of the limitation. The $475,000 balance of investment in excess of the limit would receive no investment tax credit in any year. This example clearly illustrates the discriminatory impact on small business of this limitation.

Furthermore, an established manufacturer has hardly begun to modernize before he realizes that the $125,000 ceiling offers him very little assistance at all. The original arbitrary and inadequate limit of $50,000 in 1962 was merely a token gesture to small business and in light of inflation, doubling the limit to $100,000 thirteen years later and to $125,000 nineteen years later, has perpetuated the injustice.

This discriminatory tax treatment impacts directly and primarily upon small businesses which are already hindered by their inability to externally or internally generate the capital necessary to buy equipment. Capital stock formation among small business (which may be the nation's best source of economic growth) has been impeded by high interest rates,

restricted availability of credit, the government's regulatory burdens, the prolonged recession, the tax laws which discriminate against small business. Since small business cannot generally afford or justify new machinery, it requires quick passage of tax incentives which will enable it to buy the used equipment it needs to initiate start-ups, boost productivity, expand capacity, and, thereby enhance its ability to participate in the economic recovery.

The Joint Economic Committee and the White House Conference on Small Business both have recognized the disparity between large and small businesses as they are affected by inflation and current tax policy. Both have called for tax measures targeted to small business that will enable smaller firms to retain a greater proportion of their earnings for reinvestment in capital improvements and plant expansion.

The primary way that a small manufacturer increases a plant's production capacity or develops a new product line is by purchasing additional used machines. Major corporations renew equipment which is 7 to 10 years old with new equipment, some of which costs over a million dollars. Medium to small firms renew equipment which is 15 to 25 years old or more with newer used equipment, frequently 7 to 10 years old, some of which costs over $300,000. Very small or new firms may renew their equipment which is 25 years old or more with used equipment which is frequently 15 to 18 years old. Such upgrading of equipment translates into increased productivity for a small business. If the full investment tax credit is allowed for used capital stock, it will speed up the process of renewal and upgrading of all of our industrial plants. The demand for used equipment will increase the price and market for a large firm's used equipment. This will encourage the large firm to sell its used equipment and buy new capital stock to replace the used. This will result in a significant increase in productivity throughout the economy.

Improving productivity does not necessarily require acquisition of younger machines. Often small manufacturers can increase their productivity by purchasing used equipment manufactured in the same year as its current equipment but more efficiently designed for its particular production needs.

In its 1980 Report, the Joint Economic Committee makes a convincing case for the importance of small business in improving the productivity of our system:

> In the area of innovation and productivity, the National Science Foundation has found that one out of every four of the most significant industrial product and process innovations since World War II was developed by firms of less than 100 employees, while one-half were accounted for by firms with less than 1,000 employees. (p. 71)

I believe that further investigation would reveal that an extremely high percentage of those innovative products and processes were made or developed on used equipment. Remember, new equipment is built with used equipment.

When the small businessman is denied tax incentives to replace current equipment with used machines that are either more sophisticated or more appropriate for his operation, our economy loses. His alternatives are to make do with existing equipment, to merge, to be acquired, or to close up shop.

To penalize the manufacturer who installs $1 million of used machinery in a single year over the manufacturer who merely installs $125,000 worth, simply makes no sense in a sluggish economy at a time of slowing economic growth.

We believe what influences a firm's decision to purchase used capital equipment is not fully understood, and we believe more companies make larger investments in used equipment than is perceived. The two most common factors in the decision to buy used equipment are cost and availability.

Market and/or production conditions strongly influence the capital investment decision. When a smaller manufacturer has the opportunity to increase sales, it often requires an immediate increase in production capacity. Most newly produced U.S. manufacturing equipment has from a 6 to 12 month delivery period, and this lag time could cancel the additional sales. Because they are often highly leveraged, some smaller manufacturers are not able to increase their productive capacities even with available used equipment because of the limitation on available investment tax credit. Also, even when a smaller manufacturer wishes to increase production efficiency and has the time to wait for newly manufactured equipment, he often can not obtain adequate financing to purchase highly expensive replacement machines.

It is becoming increasingly difficult to imagine competitive smaller manufacturers in the 1980's unless the capital retention opportunities for these businesses are made equal to larger manufacturers today — regardless of a wise decision to shorten and simplify capital recovery. The cash flow which results from the tax credit is urgently needed by smaller firms either for additional equipment expenditures or other corporate investments in labor, research, marketing, or facilities. This advantage to the cash position of a small business will also add to its credit worthiness in the eyes of potential lenders or investors. When a small screw machine company began operating in Des Moines, Iowa, it received a $12,500 credit for the $290,000 investment in used capital equipment. The decision to purchase used equipment was based on availability and cost. Nonetheless, this company could have used well the full $29,000 credit, perhaps for an additional sales representative, office equipment, etc.

In many instances, later year domestic used machinery and newly manufactured foreign machinery are competitive in efficiency and price. The

new foreign machine has an advantage since there is an unlimited tax credit, with carryback and carryforward provisions available to its purchasers; but purchasers of used domestic equipment, which may be as efficient as new foreign equipment, are limited to a $125,000 ceiling with no carryback or carryforward privilege for the balance of investment over the limitation. Small manufacturers seeking to retool are faced with three choices:

1. making do with inadequate equipment;
2. purchasing imported new machine tools; or
3. acquiring more efficient used machinery.

If a manufacturer retains his inadequate machinery, there is no increase in productive capability and the goal of economic growth is frustrated. Retooling with imported machine tools is obviously undesirable, both in its ultimate effects on the domestic machine tool industry and in its adverse effect on the balance of payments. Only by retooling with more efficient used machinery can the maximum economic benefits to the nation be realized. The full investment tax credit should apply to purchases of used machinery so these benefits can be realized, and so that foreign new machinery is not given a tax advantage over equally efficient domestic used machinery. To the extent that domestic used equipment is purchased instead of new foreign equipment, there would be no revenue loss from allowing the full investment tax credit for used equipment. This would also have a favorable impact on our trade deficit.

The current disparity between the investment tax credit available to new and used equipment is in effect a Congressionally mandated discrimination against small business which directly dilutes the ability of small business to compete with large firms and survive. This disparity also allows

new foreign machinery a competitive edge through the investment tax credit advantage over equally efficient and price competitive used domestic machinery. We assume this was not the original intent of the $50,000, $100,000, and $125,000 ceilings.

This Committee knows that the small business sector offers the greatest potential for increasing employment. The purchase of used machinery not only increases productivity but also directly creates new jobs. As noted earlier, small businesses increase productivity primarily with used equipment. Small business is also responsible for 55 percent of all employment in the private sector. A 1979 study by the Massachusetts Institute of Technology, The Job Generation Process, shows that job creation and replacement is achieved through the small business sector. The data shows that the largest number of new jobs emanated from very small firms with twenty employees or less. For the period of 1969 to 1976, the small firms generated 66 percent of all new jobs in the United States. Businesses with five hundred or more employees, by contrast, created only 13 percent of the new jobs. The firms of intermediate size accounted for the remaining 21 percent.

In its 1980 report, the Joint Economic Committee found that:

> 1. Given the historical tendency of the small business to employ relatively lower ratio of capital to labor than large business, each additional dollar invested in small business is likely to generate more jobs than if it were invested in large business. A policy of small business growth would have its greatest effect in decaying cities where structurally the unemployed have the most difficulty finding job opportunities. Traditionally, young people in this country use jobs in small businesses to gain the work experience needed for entry into jobs that lead to highly skilled careers. (p. 72)

It is my experience that there is a direct relation between increased purchases of used machinery and increased employment. Furthermore, the small business

owner is the last to lay off his employees. He has a strong social conscience which is relected in his dedication to his employees and his community. With targeted tax incentives like the elimination of the limitation on used machinery and equipment, small manufacturers can not only participate in the economic recovery, but they will generate the jobs necessary to lower the very high unemployment our country is currently suffering.

In this Congress, Senator Bentsen introduced S 1840, "Small Business Capital Formation and Inventory Simplification Tax Act of 1983," which included a provision to remove the limitation on the amount of used property for which the investment tax credit is allowable. Senator Bentsen stated that the purpose of this provision was "to provide a tax incentive to the small businessman to replace current equipment with used machines that are either more sophisticated or more appropriate for his operation. This measure will insure that small businesses make the capital investments necessary to remain competitive during this economic resurgence." He recognized that "a small manufacturer can increase his output by purchasing additional used machinery and increase his productivity by purchasing newer models of used machinery." Senator Bentsen concluded his statement as follows:

> We cannot maintain a healthy, competitive and growing economy unless there is enough capital available for the risktakers and the entrepreneurs who want to expand their ideas into businesses. We must also insure that these small businesses receive equitable tax treatment. These businesses represent the backbone of the American economy. The key building block for the emerging small businesses is capital. Without adequate incentives for capital formation and investment, the ongoing function of nurturing new and existing small businesses will cease.

In the 97th Congress, both the Senate and the House Small Business Committees identified the tax credit for used equipment as one of the top priorities in their capital formation and tax recommendations. When

introducing his proposal to raise the current arbitrary limitation (S. 360), Senate Small Business Committee Chairman, Lowell Weicker, stated that "the substantial small business dependence on used equipment, particularly in this high technology environment, suggests that as a matter of simple equity for our Nation's small businesses the existing ceiling on used investment should be increased, if not removed entirely." (Emphasis added.) Senator Weicker's bill would have raised the ceiling from $100,000 to $250,000. He also urged the Finance Committee to phase in an elevation of the ceiling to reach $500,000 by 1985. Senator Weicker concluded that "elementary justice" and the "improved productivity of our economy" required this basic change.

The importance of this issue is further evidenced by the fact that eight legislative proposals in the House and two in the Senate had been introduced in the 97th Congress, including Senator Weicker's bill. Senator Bentsen introduced S. 1140 which was cosponsored by Senators Danforth, Baucus, Mitchell, and Chafee. That bill would have raised the limitation to $250,000 and allow a carryback and carryforward of the cost of used equipment if it exceeds $300,000 for any taxable year. Senator Bentsen stated that he believed:

> that an increase in the regular investment tax credit for used equipment is necessary to assure that the small businesses participate in the general upgrading of productive facilities which this proposal is intended to stimulate.... Finally, by allowing a carryover of any unused tax credit, we insure that businesses make the necessary investment this year without being deterred from making such investments due to the limitation on the amount of property qualifying for the investment tax credit.

In the House, Congressman Bill Frenzel and Congressman Kent Hance introduced H.R. 1377 and H.R. 3759, respectively, both of which eliminated the limitation entirely. Congressman Tom Downey introduced H.R. 3644 which would have raised the limitation to $300,000 and allowed a carryback/carryforward

of the cost of used equipment in excess of that limitation for any taxable year. Congressmen Jimmy Quillan, Dan Marriott, Marty Russo, and Cecil Heftel introduced bills which raise the limitation to $500,000, $300,000, and $200,000, respectively.

We appreciate the efforts of these Senators and Congressmen in the 97th Congress to help on this issue. We are concerned that the mere raising of the limitation perpetuates the discrimination which is inherent in the current provisions of the tax code. The carryback three years and the carry-forward seven years of the amount in excess of the limitation which was included in a number of these bills would have helped ameliorate this discrimination against small businesses.

In 1975 the Senate Finance Committee reported and the Senate passed a tax bill which would have eliminated the limitation entirely. In 1981, the Senate Finance Committee reported a tax bill which eliminated the limitation and required a recapture of the tax credit computed upon the resale value of the used equipment. On the Senate floor this provision was dropped from the bill and Senators Weicker and Durenberger succeeded in the passage of an amendment which raised the ceiling to $125,000 in 1982 and $150,000 in 1985.

In 1981 the Ways and Means Committee reported out a bill which would have allowed expensing of all capital investments. This approach was an even-handed way of stimulating both small and big business to invest in upgrading their facilities. Unfortunately, the Senate version prevailed and the discrimination against small business was perpetuated.

Our proposal for small business relief from the discriminatory limitation on the investment tax credit for used equipment and machinery was supported in the 97th Congress by the Small Business Legislative Council (see Appendix A), the National Federation of Independent Businesses, the National

Association of Wholesaler Distributors, the National Small Business Association, as well as many other small business trade associations. In a poll conducted by the House Small Business Committee, this issue ranked in the top three of all small business tax priorities.

Unfortunately, the tax bill currently pending in Conference will defer the scheduled increase in the ceiling (from $125,000 to $150,000 in 1985) four years until 1988. This freeze proposal goes in the wrong direction because it will have an inordinate impact upon small businesses, particularly those in the industrial sector which have been hardest hit by the recession. The machine tool industry and especially the used machine tool sector has been devastated by the recession and has not yet felt any impact from the economic recovery which is currently underway. The small manufacturers which purchase used equipment currently find it difficult to make the capital investments necessary to make themselves more competitive and productive. At a minimum they need the increase from $125,000 to $150,000 in the ceiling on the amounts of used equipment eligible for the investment tax credit which is scheduled to be phased in in 1985. The freeze proposal will preclude that nominal $25,000 increase in the limitation.

Even though our industry is still struggling to participate in the recovery, we have accepted the freeze at this time as our contribution to reducing the deficit in the interest of the economy and our country. We communicated this support to Chairman Dole in a letter dated March 26, 1984. We also urged that the Finance Committee study the discriminatory impact on small business which this investment tax credit creates and that it take the necessary step of eliminating the ceiling entirely. A viable alternative to the current system would be to couple the elimination of the ceiling with a

recapture of part of the tax credit on resale. This was the approach taken by the tax bill which was reported by the Finance Committee in 1981 but was removed and replaced by the ceiling increase in a floor amendment. This approach would be either revenue neutral or achieve a revenue gain. Equal treatment of new and used equipment with a full 10 percent investment tax credit and recapture of 10 percent of the resale value (less value added) would help all businesses participate aggressively in the economic recovery.

We commend the Finance Committee for the approach it took in 1981 and urge that it give priority to passage of tax legislation which will eliminate the limitation during this Congress. The benefits to our economy which can be derived from removal of the limitation are: more competitive small businesses, stimulation of capital investment, development of creative and innovative products and processes, starting new businesses, helping small business maintain its market share and survive, expansion of capacity and productivity, increased employment, improved balance of payments, increased demand for new domestic machine tools, reduction in inflation, generation of more tax revenues, and equal opportunity for growth of all businesses.

We believe that small business is crucial to the survival of a free enterprise system, a sustained economic recovery, and increased employment. Small business is an effective force even in heavily concentrated markets, but its position is frought with difficulties. The tax laws should not further handicap small businesses by giving tax breaks to industrial giants and denying such incentives to small businesses. We urge passage of legislation that will eliminate the limitation on the investment tax credit available to purchasers of used machinery and equipment not only for the major assistance it will give small business in its capital formation efforts, but also because of the symbolic importance of the Congress going on record against discriminatory tax treatment of small business.

APPENDIX A

INVESTMENT TAX CREDIT

The decline in our productivity is caused by several conditions. For the first time in twenty years, the Joint Economic Committee Annual Report of 1979 unanimously concluded that an increase in productivity is vital to the improvement of our economic standard of living and to the reduction of inflation. A partial cause of this situation is the antiquated production facilities of many American manufacturers. Another partial cause is the utilization of inefficient equipment; and yet another partial cause is the overall age of our country's industrial machinery. The most recent U.S. survey of machine tools shows only 11% of the industrial machinery in use today is less than five years old; 76% is at least ten years old. Equipment renewal and upgrading are necessary in both large and small manufacturing companies. Increasing productivity through equipment renewal is best achieved for small business through the purchase of affordable used machinery and equipment.

Under present law there is a $100,000 limitation on the amount of used equipment eligible for investment tax credit, but there is no limitation on the investment credit available for new equipment. This discriminatory tax treatment impacts directly and primarily on small business which is already hindered by its inability to externally or internally generate capital necessary to buy new equipment.

In order to increase productivity and competition, the discriminatory ceiling on the amount of used property eligible for a tax credit must be eliminated; and, the carryover provisions available for new property must also be available for similarly situated used property. Traditionally, small businesses purchase used capital equipment; large businesses basically purchase newly manufactured capital equipment. The cost of obtaining capital for production equipment is high for everyone, especially those who cannot borrow at the prime rate. Firms purchasing used capital equipment do not have a chance to offset some of their costs through this tax credit. Confining the investment credit to only equipment with the latest technology helps primarily the largest enterprises and basically ignores the numerically greater small business segment of our economy which needs this tax credit the most. Because the small business sector offers the greatest potential for increasing employment, there is normally a direct relationship between increased installation of used machinery and increased employment.

RESOLVED

Small Business Legislative Council urges and supports changes in the IRS Code to allow a full investment tax credit for used machinery and equipment. This full investment tax credit will allow small businesses to receive the same tax incentive provided to big businesses and would allow small businesses to compete, to maintain their current market share, and to hopefully expand output and productivity.

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Small Business Legislative Council*

July 30, 1980

The position paper -- Investment Tax Credit -- is supported, as of this date, by 51 members of the Small Business Legislative Council:

American Assn. of MESBICs
Washington, DC

American Assn. of Nurserymen
Washington, DC

American Metal Stamping Assn.
Richmond Heights, OH

Assn. of Diesel Specialists
Kansas City, MO

Assn. of Indep. Corrugated Converters
Washington, DC

Assn. of Physical Fitness Centers
Bethesda, MD

Automotive Warehouse Distribs. Assn.
Kansas City, MO

Bldg. Service Contractors Assn. Intl.
Vienna, VA

Business Advertising Council
Cincinnati, OH

Christian Booksellers Assn.
Colorado Springs, CO

Direct Selling Association
Washington, D.C.

Eastern Manufs. & Importers Exhibit
New York, NY

Electronic Reps. Assn.
Chicago, IL

Independent Bakers Assn.
Washington, DC

Indep. Business Assn. of Michigan
Kalamazoo, MI

Indep. Sewing Machine Dealers of Americ
Hilliard, OH

Intl. Franchise Assn.
Washington, DC

Local and Short Haul Carriers Natl Conf
Washington, DC

Machinery Dealers Natl. Assn.
Silver Spring, MD

Manufacturers Agents Natl.
Irvine, CA

*Of the National Small Business Association

Marking Device Assn.
Evanston, IL

Menswear Retailers of America
Washington, DC

MN Assn. of Commerce & Industry Small Business Council, St. Paul, MN

Narrow Fabrics Institute
New Rochelle, NY

Natl. Assn. of Catalog Showroom Merchs.
New York, NY

Natl. Assn. of Floor Covering Distribs.
Chicago, IL

Natl. Assn. of Plastic Fabricators
Washington, DC

Natl. Assn. of Plastics Distribs.
Jaffrey, NH

Natl. Assn. of Retail Druggists
Washington, DC

Natl. Candy Wholesalers Assn.
Washington, DC

Natl. Coffee Service Assn.
Chicago, IL

Natl. Electrical Contractors Assn.
Bethesda, MD

Natl. Family Business Council
West Bloomfield, MI

Natl. Home Improvement Council
New York, NY

Natl. Independent Dairies Assn.
Washington, DC

Natl. Insulation Contractors Assn.
Washington, DC

Natl. Meat Assn.
Washington, DC

Natl. Office Machine Dealers Assn.
Des Plaines, IL

Natl. Paper Box Assn.
Haddonfield, NJ

Natl. Paper Trade Assn.
New York, NY

Natl. Parking Assn.
Washington, DC

Natl. Patent Council
Arlington, VA

Natl. Pest Control Assn.
Vienna, VA

Natl. Small Business Assn.
Washington, DC

Natl. Society of Public Accountants
Washington, DC

Natl. Tire Dealers & Retreaders Assn.
Washington, DC

Natl. Tooling and Machining Assn.
Washington, DC

Natl. Tour Brokers Assn.
Lexington, KY

Power & Comm. Contractors Assn.
Washington, DC

Printing Industries of America
Arlington, VA

Sheet Metal & Air Cond. Contrs.
Natl. Assn., Vienna, VA

NATIONAL TAX EQUALITY ASSOCIATION

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June 6, 1984

Senator Charles E. Grassley
Chairman
Senate Finance Subcommittee
on Oversight of the Internal Revenue Service
Senate Dirksen Office Building
Washington, DC 20510

Dear Senator Grassley:

The National Tax Equality Association appreciates this opportunity to present to you and members of your committee our views on the use of tax preferences and economic productivity. Our 1500 business members, including many smaller businesses are increasingly concerned about tax favoritism for certain groups or business segments that may interfere with market decisions made by consumers and investors. Our testimony for these hearings centers on the advantages provided certain nonprofit corporations.

It is apparent that Congress has and continues to provide special tax treatment to specific constituents and sectors without regard to the aggregate economic impact of the tax favoritism. Examining specific provisions of the tax code that allow special treatment with an eye for determining which provisions may be inefficient and outdated due to the extensive changes our economy has gone through in the past fifty years is a difficult, complex project. But, we believe it is necessary for reasons of fairness and also because of the need to reduce huge Federal budget deficits which threaten continued economic recovery.

We commend your effort to initiate dialogue on these important issues, and we look forward to the continuing series of hearings.

Thank you.

Sincerely,

Edward N. Delaney

Edward N. Delaney
President

Enclosure: Research Analysis of Tax Favoritism for Nonprofit Corporations

INTRODUCTION

The National Tax Equality Association supports a reform of Federal tax policy regarding the establishment of a more neutral corporate tax system. Disparities in tax rates from business to business within industry sectors and also from industry to industry creates competitive inequality resulting in economic inefficiency. An area of tax inequality of particular concern to this association involves special tax benefits and exemptions for commercial non-profits who compete with tax-paying businesses.

In a November 1983 report entitled "Unfair Competition By Nonprofit Organizations with Small Business: An Issue for the 1980's," the Small Business Administration examined the impact of providing regulatory and tax advantages to non-profits actively pursuing commercial business. The report found that the non-profits "represent a source of significant and frequently unexpected competition for small businesses operating in the same industry." The report went on to suggest some specific remedies for the problem in legislative changes in Federal tax laws and procurement law. The NTEA generally endorses the report and finds the investigation a worthwhile contribution to the dialogue on this very specific and highly important problem. We do, however, urge the SBA to continue to examine the entire small business community to broaden the scope of information available on non-profit competition with for-profit business.

To assist in this effort, we are providing an analysis of the growing problem of competitive equity between non-profit cooperative corporations and small businesses in the following report.

Cooperatives are business enterprises in which the customer or "patron" of the firm is also the owner. Most co-ops are organized under state incorporation laws and thus possess the peculiar corporate legal characteristics of limited liability, entity status, and perpetuity. The act of incorporation establishes a legal entity with an existence independent and apart from its owners. Individuals who form cooperatives constitute a group wishing to consolidate their buying power in order to increase the financial benefits of the marketplace. Traditionally, the co-op has had the reputation as a "self-help" organization for groups of individuals perceived to be at some economic disadvantage. This is no longer a common trait for cooperatives, as hardware co-ops, office supply co-ops, energy related co-ops and many others accept all income groups as participants for the purpose of maximizing financial benefits.

As a corporation, the co-op enters into contracts in its own name and the patrons are not bound by the corporate acts. Co-ops operate for their own account and retain corporate employees. The legal relationship between the co-op and its owner-patrons is essentially identical to that of any other corporation.

The cooperative structure includes three basic tenets that are absent in investor-owned businesses. First, the earnings of the co-op are distributed to the owners on a basis of patronage. Second, the return on capital is usually limited to a maximum of 8 percent. Third, the amount of stock ownership which any one individual stockholder may possess is limited, and that, regardless of the amount owned, each stockholder has only one vote at the stockholder's meeting.

Cooperative businesses are usually associated with agribusiness, and most of the total revenue dollars of co-ops are in the agribusiness sector, but the cooperative business format also has developed or is developing in a number of business sectors including furniture retailing, grocery retailing, financial consulting, energy related businesses and auto parts supply and repair and hardware supply. [1] As of 1983, eight co-ops were listed on the Fortune 500 list of largest industrial corporations and nine on the Fortune Service 100 list.

Cooperative growth continues, and, NTEA maintains that this growth is due to individuals' desire to obtain the benefits of favored government policy.

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1 For instance, Cotter & Company, a wholesale hardware cooperative is exempt from federal income taxes on all profits distributed or allocated to members as patronage dividends. Cotter & Company, and its cooperatively held subsidiary, True Value Hardware, had sales volume of $1.35 billion in 1981.

This analysis will concentrate on the tax benefits available to co-ops, and how such benefits provide competitive advantages and damage competing small businesses. Before we look at that subject further, please take a moment to consult the following table, which indicates the size of today's dominant cooperatives.

Table I This chart shows cooperatives on the Fortune 500 and Service 100 list along with total sales figures and rankings.

COOPERATIVE	SALES (in thousands)	Fortune 500 1983 Rank	Service 100 1982 Rank
Agway	3,768,212	98	
Land O' Lakes	3,264,792	121	
Gold Kist	1,461,424	238	
Farmer's Union Central Exchange	1,409,085	243	
Mid-America Dairyman	1,356,622	247	
CF Industries	862,048	328	
National Cooperative Refiner Assoc.	784,360	348	
Michigan Milk Producers Association	562,038	430	
Sun Diamond Growers of California	522,199	447	
Wisconsin Dairies Cooperative	447,555		
Farmland Industries	5,614,439		6
Associated Milk Producers	2,634,778		15
AGRI Industries	2,317,988		20
Grain Terminal Association	2,309,463		21
Dairymen	1,152,430		50
Southern States Cooperative	684,834		76
Sunkist Growers	688,834		77
Landmark	644,723		81
Union Equity Exchange	639,355		83

SUMMARY OF FEDERAL INCOME TAX TREATMENT OF COOPERATIVES

I. INTRODUCTION

Corporations operating on a cooperative basis fall into several categories insofar as their federal income tax treatment is concerned.

This section summarizes the tax situation respecting cooperatives in the ordinarily understood sense. The tax treatment of such organizations is covered by IRC §521 and Subchapter T of the Internal Revenue Code which is entitled "Cooperatives and their Patrons." Subchapter T specifically excludes from its coverage a group of specialized institutions, such as mutual savings banks, rural electric and telephone cooperatives, and certain charitable organizations, each of which is especially provided for either in other parts of the Internal Revenue Code or in the substantive law governing the institution.

The cooperatives with which NTEA is concerned may be divided into three major categories: tax-exempt farm cooperatives; nonexempt farm cooperatives and nonfarm cooperatives. These categories are treated alike in at least one major respect. Specifically, patronage dividends which cooperative corporations allocate to their patrons may be deducted in determining taxable income of the cooperative provided the patron consents to take the same amount into his own individual income tax liability.

II. CURRENT FEDERAL INCOME TAX TREATMENT OF COOPERATIVES

Cooperatives generally, whether farm or nonfarm, whether exempt or nonexempt, may deduct the face amount of certain distributions made to their patrons in computing their taxable corporate income.

Sections 1381 to 1388 of the Internal Revenue Code provide the method of computing the taxable incomes of cooperatives and their patrons. These sections were enacted in the Internal Revenue Act of 1962. Prior to that legislation, cooperatives had been allowed to exclude from their income the face amount of noncash patronage dividends while the patrons, although required to include the fair market value of these patronage dividends, valued them at zero. Since only the fair market value of the distributions was subject to individual income taxation, the patron also avoided federal income tax. The Internal Revenue Act of 1962 attempted to close this loophole under which neither the cooperative nor the patron paid any tax on non-cash patronage dividends. The theory of the 1962 act was to assure that these distributions would be taxable to either the cooperative or the patron. Briefly, the Act required that in the case of noncash dividends, at least 20% of the distribution must be in cash and the patron must include, in his individual income, the face amount of noncash distribution--even if there was no fair market value.

The present state of cooperative taxation, and the main area of concern to the National Tax Equality Association, is the continued ability of co-ops to deduct from their taxable income allocations known as patronage dividends or, in the case of marketing cooperatives, per-unit retains. After taking the deductions for patronage dividends and/or per-unit retains, the cooperative is subject to the regular corporate income tax rates.

All of the federal income tax law applicable to cooperatives, enacted since 1962, has related to patronage dividends or per-unit retains.

1. Patronage Dividends

Patronage dividends are distributed by a cooperative to its patrons out of the earnings of the cooperative. Patronage dividends may be paid in money, property or certificates of allocation. Patronage dividends are defined as amounts: (a) distributed under an obligation existing before the paid amount was earned by the organization, (b) determined on the basis of business done with or for the patron, and (c) determined by reference to net earnings from business done with or for patrons. IRC §1388(a). These amounts, patronage dividends, may be deducted from gross income of the cooperative under certain conditions. The principle condition is the previous consent of the patron to include the same amount in his individual income. To be deducted by the cooperative for a particular taxable year, the patronage dividend must relate to patronage during that year and

must be paid or allocated to the patron within 8-1/2 months after the end of the year. If a noncash notice of allocation is declared then 20% or more must be in the form of money, or qualified check. IRC §1388(c). This provision effectively allows the cooperative corporation to retain 80% of the declared dividend as tax-free at the corporate level. While considering the Tax Reform Act of 1969, the House of Representatives enacted a provision to increase the 20% cash payout to 50%; but this provision was not adopted by the Senate and did not become law.

2. Per-Unit Retains

A per-unit retain certificate is issued to a patron to reflect the retention by the cooperative of a portion of the proceeds from the marketing of products for the patron. Through the Revenue Act of 1966 and the Tax Reform Act of 1969, per-unit retains are treated equally, for deductibility purposes, as patronage dividends. In other words, cooperative corporations are allowed to deduct amounts allocated to their patrons as per-unit retains. Again, the patron must include the amount allocated to his account in his gross individual taxable income. See generally IRC §1385.

III. SUMMARY

Cooperatives are nominally subject to corporate rates of taxation. However, co-ops are allowed a deduction from taxable income equal to the amount of co-op earnings allocated to the co-op patron. This allocation is usually referred to as either a patronage dividend or a per-unit retain.

Patronage dividends and per-unit retains do not need to be cash payouts to qualify the co-op for the deduction. The tax code only requires that 20% of the dividend be in cash. The balance may be returned to the patron in certificate form--bearing no interest. The patron pays individual income tax on the entire allocation, whether cash or certificates. This creates cash flow difficulties for many farmers who are already experiencing income problems. Some have suggested that the co-ops be required to pay cash dividends of at least 50% rather than 20% if they are to benefit from special deductions. NTEA agrees that would be a reasonable policy. Currently, the co-op may retain--in corporate control--80% of the declared patronage dividend as untaxed capital to be used for expansion, merger and market competition.

This system of taxation is obviously much different from that of non-cooperative corporations. The income of non-co-op corporations is subject to federal taxation at two levels--corporate and individual (when distributed as dividend income)--while cooperative earnings are virtually tax-free at the

corporate level. The different tax treatment clearly places the co-op at an advantage when competing with non-cooperative enterprises.

The following table 2 of this report outlines the effective tax rates for large cooperative companies for the years 1982 and 1983. Co-ops examined include those listed on the Fortune 500 and Service 100 that responded to request for annual reports.

Table 2 Tax Rates for Cooperatives listed on Fortune 500 and Service 100 List

Part 1 Effective corporate taxation of cooperatives for 1982.

		Tax Rate	Income
1)	Farmers Union Central Exchange	4.8%	$15,927,967
2)	Dairymen	2.7%	$14,755,000
3)	Goldkist	24.0%	$ 7,181,000
4)	Sun-Diamond	0.2%	$278,354,000
5)	Sunkist	1.0%	$493,160,000
6)	Southern States Co-op	18.6%	$ 11,257,630
7)	Wisconsin Dairies	2.0%	$ 7,145,438
	AVERAGE TAX RATE	7.6%	

Part 2 Effective corporate taxation of cooperations for 1983

1)	Agway	23.3%	$20,695,000
2)	Dairymen	1.7%	$ 6,234,000
3)	Landmark	32.4%	216,000
4)	Sun-Diamond	0.2%	$279,111,000

5)	Southern States Co-op	23.9%	$ 3,992,259
6)	Wisconsin Dairies	2.0%	$ 8,711,712
7)	Goldkist	2.0%	$ 3,883,000
	AVERAGE TAX RATE	12.2	

A number of cooperatives had negative tax rates. While the special dividend deductions available to these co-ops help to reduce their tax obligations, they also had extensive investment tax credit, rapid amortization, or carryovers. These were not included in the analysis. Also, co-ops that showed a loss for either tax years were not included.

Section III NEGATIVE EFFECTS ON THE U.S. ECONOMY

Section I of this paper has demonstrated that non-profit cooperative earnings remain untaxed at the corporate level as long as the earnings are allocated to an individual patron who has consented to include the same amount in his individual taxable income. This reduced co-op tax liability is known as a "tax expenditure." Recent estimates prepared by the staff of the Joint Committee on Taxation indicate that this tax expenditure is approximately $600 million in fiscal year 1984, and will exceed $1 billion by 1989. [2] This figure becomes even more startling when we recognize that it measures only the tax expenditure

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[2] Estimates of Federal Tax Expenditures for Fiscal Years 1983-1988', Joint Committee on Taxation, p. 11 (March 7, 1983).

benefiting the agricultural cooperatives, a mere 10 percent of all U.S. cooperative corporations. As cooperatives continue to grow, so will this tax expenditure. It must be noted here that when the government requires a certain level of tax revenue to meet its budgetary needs, a shortfall in incoming receipts must be met by other sectors of the economy, or result in deficit spending. We must assume that all U.S. taxpayers are faced with increased tax burdens in order to offset the tax expenditure given to the cooperative corporations. Again, as cooperatives grow, so grows the tax expenditure, and so grows the resulting tax burden of the non-cooperative U.S. taxpayer.

However great the loss of federal revenue actually is, it is still a minor consideration when compared with the significance of the co-op tax privilege as an impediment to growth of competing small businesses.

Tax exemption or special tax privileges tend to subsidize the recipient, in this case, the cooperative corporation. Subsidies are sought because, admittedly, they lower the real costs of operation and shift those costs to other sectors of the economy. NTEA contends that the cooperative tax subsidy shifts a corresponding amount of the co-op operational costs directly to the government and indirectly to competing businesses, as well as taxpayers generally.

Artificially low real costs of operation clearly provide a cooperative corporation with a competitive advantage over conven-

tional taxpaying businesses. Businesses that may be superior because of greater efficiency may be driven from the marketplace by those businesses that are subsidized. Examples of the increasing market domination of cooperatives are presented in Section IV. It must be remembered that when a cooperative increases its market share of an industry, then the non-cooperative market share is correspondingly decreased. Basically, in such a situation, taxpaying businesses are displaced by tax-favored cooperative corporations.

If cooperatives continue to be subsidized through special tax privileges then gradually, but most assuredly, many small businesses will be displaced. Resources will be shifted. When this occurs, and it has in the dairy industry, for example, then competition ceases to exist. Established economic thinking, the basis of which is the traditional theory of American enterprise, holds that a lack of competition generally results in higher prices and lower output. Clearly, the economy suffers from this tax-induced decline in competition.

Some commentators (usually cooperative spokesmen) claim that the special tax treatment for co-ops is designed to assist, and does assist, the individual patron; the farmer in an agricultural cooperative. While this position was valid years ago, the benefits for farmers or other co-op patrons are now less apparent. This is because the portion of the patronage refund returned to

the patron in cash is quite small in comparison with that locked into cooperative equity.

The difficulties a farmer-member faces in getting the co-op to which he belongs to redeem his equity investment is certainly detrimental. Officials of the Farmers Home Administration (FmHA) in the USDA say it is becoming increasingly difficult for farmers to repay loans. The national rate of delinquency on payments is the highest in memory--58 percent. Perhaps this delinquency rate would be lower if the cooperative paid out a greater percent of the patronage dividend in cash.

Supporters of the current cooperative taxation scheme have also claimed that this tax savings on the part of the cooperative is passed along to consumers in the form of lower prices and is therefore desirable. NTEA does not subscribe to this view because, as was stated above, tax privileges tend to diminish competition and it is competition which generates lower prices. Also, regardless of the truth of any price savings, NTEA again maintains that the increased amount of taxes which the consumer-taxpayer must pay because of the tax expenditure to the cooperative corporation offsets any price benefit.

Section IV COOPERATIVE MARKET GROWTH

Statistics compiled by the U.S.D.A. indicate that the number of U.S. agricultural cooperatives is declining, reflecting a continuing trend of co-op merger, consolidation and acquisition.

While the exact number of non-agricultural U.S. cooperatives is not available, the Cooperative League of the U.S.A. estimates there to be at least 45,000 non-profit cooperative businesses now operating. All of these co-op enterprises, agricultural and non-agricultural, compete in the marketplace under a favored Federal income tax status.

The consolidation and merging of cooperative business has coincided with a period of tremendous growth in co-op business volume and overall market share. For example, net agricultural cooperative marketing volume for the top 100 has increased from $6.4 billion in 1950 to a record $57.8 billion in 1981. Cooperative business volume consists of marketing products, sales and supplies and receipts from related services such as trucking, storage, etc. The sales volume of the top 100 co-ops represents an estimated 57 percent of all U.S. co-op business volume.

The growth in market share per product is equally astounding. Between 1950 and 1974 cooperatives' share of the total grain market jumped from 28 percent to 44 percent. In this same period, the cooperative market share of dairy and milk products climbed from 48 percent to 77 percent. Meanwhile, the share of the farm market supplied by purchasing cooperatives also increased dramatically. Cooperatives doubled their share of the fertilizer market, from 15 percent to 30 percent. The amount of petroleum products sold by cooperatives rose from 21 percent to

30 percent, an increase of about 50 percent.

As the market share of the cooperatives has increased, the proportion of the market held by private business has declined. The NTEA does not attribute this phenomenal cooperative market growth entirely to their special tax status. Additionally, cooperatives enjoy other favorable government policies. NTEA, and other groups, question the merits of continuing to favor the well-entrenched cooperatives.

Tax Discrimination and Antitrust Immunity

The detrimental effects arising from the tax exemption of cooperative corporations are exacerbated by the antitrust immunity granted them under the Capper-Volstead Act. This Act has been loosely interpreted to allow, within a certain undefined sphere, the exercise of monopoly power by cooperatives. The Act permits cooperatives to raise prices, although section 2 of the Act prohibits "undue price enhancement"--unfortunately without defining precisely what this phrase means. Courts have interpreted the Act in such a way as to extend a significant degree of antitrust immunity to cooperatives, especially with respect to section 1 of the Sherman Act, and section 7 of the Clayton Act, which restricts mergers injurious to competition.

In addition, section 6 of the Clayton Act widens the cooperative antitrust immunity even further.

The result has been increasingly centralized local and regional markets for agricultural products--demonstrated by abnormally high concentration ratios. This problem is particularly acute in the dairy industry, where, according to a Department of Justice study, "In December 1970, in nine of the sixty-two federal orders, 100 percent of all producers serving the market belong to one cooperative. In more than half (thirty-two) of the orders, 80% or more of the producers in the order market belonged to one cooperative." [3]

Their antitrust immunity has enabled cooperatives to take over many private firms and other cooperatives with impunity. Funded by the capital generated by tax subsidies, cooperatives, like other types of business, find expansion through acquisition of private firms is steadily eroding the corporate tax base, thereby increasing the tax burden of the remaining taxpaying concerns. This only accentuates the effects of tax discrimination and further accelerates the trend towards cooperative concentration.

The resulting concentrated structure of many agricultural markets is most conducive to the exercise of monopoly power. Although this situation is problematical enough, the tax exemption and market order system together may generate a further

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3 Department of Justice, Federal Milk Market Orders and Price Supports, 1976.

tendency towards cooperative monopoly. As noted in an FTC staff report, "In practically every market where a cooperative has achieved a dominant position in its market, that market has been regulated through either a federal or a state marketing order or both. The evidence . . . does suggest that marketing order provisions facilitate the preservation and spread of market power by a dominant cooperative and may increase the returns to a cooperative. [4]

There is widespread recognition among economists that one of the most essential prerequisities for effective competition and economic efficiency is freedom of entry. However, the general effect of most federal market orders is to limit or prevent free market entry. [5] Because of the foreclosure of new entrants by the market orders, dominant cooperatives, flushed with tax subsidies, can concentrate on the elimination of existing competitors by predatory pricing, and then take over their undervalued assets through acquisition. Certainly a most glaring example of manipulation of market orders and predatory behavior is that of Associated Milk Producers, Inc., which according to the Department of Justice, has utilized such tactics to establish

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4 Federal Trade Commission, Staff Report on Agricultural Cooperatives, 1975, p. 138.

5 See National Commission for the Review of Antitrust Laws and Procedures Report, 1979, p. 266.

a monopoly of milk production throughout much of the central United States.

The Capper-Volstead Act supposedly grants only a limited antitrust immunity to cooperatives, and section 2 of the Act authorizes the Secretary of Agricultural to police and eliminate "undue price enhancement." But in the entire time since the Act became law, the secretary has never once reprimanded a cooperative for the exercise of monopoly power. The National Commission for the Review of Antitrust Laws and Procedures noted that, "The Commission is concerned that the Capper-Volstead Act creates the potential for cooperative monopoly . . . . Testimony before the Commission shows that the threat of monopoly by some cooperatives is now substantial . . . in the future less than twenty cooperatives will control the nation's milk supply. [6]

Ultimately, of course, it is the American consumer who foots the bill for the monopoly pricing of cooperatives. According to a Department of Justice study, the milk market order system alone is costing consumers about $100 million each year.

SUMMARY--SOLUTIONS

Cooperatives provide useful services to their owners, and have afforded member-producers with a suitable corporate form with which to market their products. But it is an illusion to

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[6] National Commission for the Review of Antitrust Laws and Procedures Report, 1979, p. 258-259.

believe that government promotion of cooperative monopoly power constitutes anything other than a means of transferring wealth from consumers to producers. As such it is at variance with the principles of a free market economy and consumer sovereignty. The differential tax treatment of cooperatives and conventional corporations means that in the long run, capital invested in the cooperative sector earns a higher rate of return than the same capital invested in the non-cooperative sector. The result of such differential rates of return is inevitable.

Capital will flow to those markets where its after-tax rate of return is highest. In the long run, non-cooperatives simply cannot compete with cooperatives in the same markets. The steady growth in market share by cooperatives is ample demonstration of this point. The absence of competition, in any market, tends to drive prices up and output down. Only equal competition serves the best interests of both the consumer and the producer.

Now is the time to put cooperatives and conventional corporations on an equal competitive footing so that the entire U.S. economy may benefit from the economic effects of competition. Now is the time to end this area of income tax favoritism that results in nearly $1 billion in uncollected federal revenues.

Suggested solutions to this situation of federal income tax favoritism follow.

Suggested Solutions

(1) Tax co-ops in the same manner as ordinary corporations This suggestion taxes all business corporations including cooperatives in the same manner and on the same basis. It makes cooperative corporations bear their fair share of the tax burden, and is the only solution that achieves total tax justice.

(2) Increase co-op cash payouts In order to ease the competitive advantage of cooperatives, NTEA suggests increasing the required cash payout (currently 20 percent) to at least 50 percent of cooperative patronage dividend distributions. This would result in greater competitive equality through a reduction in the cooperative pool of tax-free capital. Note this solution was suggested, and agreed to by the U.S. House of Representatives in 1969, but did not pass the Senate.

(3) Repeal of the corporate income tax on dividends distributed to shareholders Although this proposal would be a step towards co-op -- private investor corporate tax equality, it has several disadvantages, mainly political.

(4) Excise tax on cooperatives It would not be unconstitutional to levy on cooperatives an excise tax measured by their net income. For those who insist that cooperative corporations have no taxable income, an excise tax equal to the income tax for corporations might be the answer.

Although NTEA regularly advocates taxing the net margins of cooperatives in the same manner as ordinary corporate profits (suggestion #2), we believe that any of the above suggestions (suggestions #2-5) represent a step towards tax equality and certainly warrant Congressional consideration and investigation.